March 1991

A Report

from

Ernst & Young

Industry, Science and Technology Canada

A Preliminary Study of the Competitiveness of Distribution Channels

Ernst & Young

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March 31, 1991

Ms. Alison Atkins
Manager, Distribution Services
Industry, Science & Technology Canada
235 Queen Street, Room 1054 East
Ottawa, Ontario
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Dear Ms. Atkins:

Re: A Preliminary Study of the Competitiveness of Distribution Channels

We are pleased to submit the above mentioned final report to Industry, Science and Technology Canada. This study was prompted by increasing levels of cross-border shopping and the need to understand differences in mark-ups from source to purchase by the final consumer for selected product categories in Canada and the U.S.

Our study provides a preliminary assessment of the issues which affect the price competitiveness of Canadian distribution channels. This should assist in understanding relative price levels in Canada, and what additional information would be useful for all stakeholders in the development of their responses to cross-border shopping.

We have enjoyed working with you and your colleagues on this important undertaking. If you have any questions regarding this report, please call Ian Gordon or Jim Buchanan at 864-1212.

Yours very truly,

Ernst & Young

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c.c. Ian Gordon
Jim Buchanan

Founded in 1932 as Woods Gordon, Ernst & Young provides general consulting and information technology expertise to Canadian business, governments and public agencies

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1. EXECUTIVE SUMMARY

Cross-border shopping by Canadians has increased dramatically over the last three years and results in retail sales losses to Canadian retailers of over $2 billion nationally. Part of the reason for cross-border shopping is the price differential between products available for sale in Canada and similar products in the U.S. Although studies have been done on the relative costs incurred by retailers on such items as taxes, little or no work has been done to understand the nature of the price differentials as goods move from source through channels of distribution in both Canada and the U.S., nor the components or underlying causes of the price differences.

For these reasons, ISTC decided to initiate a research program on distribution channel price competitiveness. The assignment began with a focussed study to identify preliminary issues of relevance which was to provide the basis for development of a research agenda and methodology which could be undertaken in subsequent phases of the project to expand its scope or coverage.

This preliminary study was limited to examining three distinct product categories - consumer electronics, bedding and linen, and women's sportswear - and was constrained by available time and budget.

Our approach to the project was to conduct secondary research through database searches, contacts with institutions, governments and associations as well as statistical analyses from government sources. We supplemented these data by conducting 33 telephone interviews with distribution channel participants in the three categories identified.

Although the three product categories covered in this research were diverse, the following observations apply to all three:

- U.S. prices are often lower because firms at all levels of the channel, but especially those highest in the chain (nearest the source of supply), benefit from scale economies driven by greater volumes;
- Price competition in the U.S. is more intense, driven in part by competition not only within a given channel (e.g. many retailers competing on an equal footing), but between channels (such as manufacturer-owned direct outlets competing with indirect channels, a less common occurrence in Canada);
- U.S. retailers in some product categories operate with lower margins than their Canadian counterparts due to cost and volume differences, as well as pricing decisions;
- U.S. firms tend to have lower operating and overhead costs than Canadian firms. Some of these costs are managed to their low levels in the U.S., but other differences are the product of the business environment, such as the relatively higher real estate costs and tax costs in Canada;
- Canadian costs are also higher as a result of duties, double handling for U.S.-based imports, warehousing and transportation as well as additional labelling requirements.

- The relative strength of discounters among retail channels in the U.S. (particularly manufacturer-owned factory outlets) has put additional pressure on margins throughout the distribution chain.

This report provides additional conclusions and preliminary findings in Chapter 7. We have also provided a series of possible additional and related research topics for ISTC, or others, to consider undertaking over the next year.

A glossary of terms is provided in Appendix C.

2. BACKGROUND

2.1 Cross-border Shopping

Cross-border shopping by Canadians has increased dramatically over the last three years. People living near the border are shopping more frequently, and spending more on goods and services in the U.S. People living up to four hours from the border are increasingly spending weekends in the U.S. to shop. We estimate retail sales losses to Canadian retailers to be in excess of $2 billion, having an obviously major, negative financial impact on this sector, particularly those retailers situated close to the U.S. border.

The impact of cross-border shopping does not stop at the retail level. The federal and provincial governments are losing considerable tax revenue. For example, Ernst & Young estimated that the total tax loss, excluding income taxes, was $15 million in Sault Ste. Marie, Ontario, alone during 1990.

There is considerable evidence that Canadian retail prices on many goods are not competitive with those found in the U.S. retail outlets frequented by Canadians. Costs of goods sold are generally the largest cost incurred at the retail level and there is some evidence that these costs are higher in Canada, thereby affecting retailer competitiveness. The underlying competitiveness of the distribution channels which add costs to products needs to be determined.

For these reasons, ISTC decided to initiate a research program on channel competitiveness which began with a focussed study to identify preliminary issues of relevance and to provide the basis for the development of a research agenda and methodology which could be undertaken in subsequent phases of the project to expand its scope or coverage.

2.2 The Purpose

The purpose of the project was to conduct preliminary research and analysis on the channels of distribution for selected product categories in the U.S. and Canada, to identify major issues affecting costs and pricing and recommend further research initiatives.

2.3 The Scope

This research project was subject to severe time and budget constraints. Research efforts were to be focused by product category and geography to enable the assignment to be completed within these limitations. The number of product categories to be examined and the specific products to be compared were identified first.

Number of Categories

A study of the competitiveness of distribution channels in Canada obviously would be a huge undertaking if all major categories of goods, all retail types, and all geographical differences were to be explored.

In determining the number of categories of goods which could be covered in a more modest assignment, we categorized channels according to the final merchandiser (mass merchandisers, specialty retailers, and factory-outlet stores) and estimated the number of interviews required to

secure the required information.

It was estimated that approximately 31 interviews would be necessary to cover three categories of goods on both sides of the border as shown in Table 1. Given the difficulty of making 31 successful interviews (i.e.. where satisfactory co-operation is received) and the possibility of greater numbers of interviews being required due to additional intermediaries being present in the channel, it was agreed that three categories of goods were the greatest number that could reasonably undertaken in the time and budget available.

TABLE 1
Target Interviews

	CANADA	U.S.
RETAILERS	- one mass - 3 specialty	- one mass - 3 specialty - 3 factory-owned
INTERMEDIARIES	- 2 for each of 3 product categories	- 2 for each of 3 product categories
MANUFACTURERS	- 1 for each of 3 categories	- 1 for each of 3 categories

Product Categories

It was decided to use the findings of previous Ernst & Young border-shopping studies to assist with the selection of product categories to be reviewed. This would provide a guide as to the types of products which typical Canadian shoppers purchase in the U.S. Gasoline, alcohol, food items. and high value goods (e.g. motor vehicles) were deemed to be not relevant for this study.

Samples of B-15 forms (for payment of duty and taxes at the border), which Ernst & Young collected while undertaking studies of the cross-border shopping phenomenon in Sault Ste. Marie and Thunder Bay, were examined. The B-15 forms from each study cover a 12 month period. Although the periods are not identical, they are representative and we do not feel that this undermines the validity of the results generated.

A new database was created, by merging the data from the two earlier studies. In order to generate a ranking sufficiently segmented for product analysis, we sorted by the first 4 digits of the Harmonized System of Tariffs number for each good, and ranked the data by their value for duty, the number of packages purchased, and the number of trips taken to purchase those goods. None of these lists produced a ranking suitable for use in determining the best products to examine in this study, for reasons outlined below.

We had anticipated that a ranking based on the value of the products purchased would yield a usable list, but, as shown in Table 2, the product ranking produced is skewed by a relatively few purchases of large-ticket items, including cars, boats, tractors and trailers. We do not believe that

this is a suitable representation of the type of goods being purchased by the average Canadian shopping in the United States.

TABLE 2
A Sample of B-15's Filed at Sault Ste. Marie and Thunder Bay Ranked by Value for Duty

Ranking	4-Digit Harmonized System Number	Product Description
1	9804	exemptions & overages
2	8703	motor cars & other motor vehicles
3	8903	yachts & other vessels for pleasure or sports
4	8716	trailers and semi-trailers, & other vehicles, not mechanically propelled & parts
5	8701	tractors
6	9403	other furniture
7	4418	builders joinery & carpentry of wood
8	8433	harvesting or threshing machinery
9	8708	parts & accessories of motor vehicles
10	9406	prefabricated buildings

Sorting the products by the number of packages and number of trips produces rankings in which exemptions and overages, beer, liquor, and groceries are among the most purchased goods. These listings are also not the most appropriate for use in this study.

Another way to look at the relative importance of the items purchased is to examine the category of exemptions and overages. Exemptions are summarized on B-15 forms in cases where a portion of the value of the good being purchased is allowed duty-free entry, based on the length of the cross-border visit. However, duty must be charged on the balance of the value of the good, *the overage*, since it exceeds the allowable exemption.

The data used in this analysis were from the Thunder Bay study database. Generally people claiming goods under these categories have been out of the country more than 48 hours, and exceeded allowable exemptions. We went back to the source forms for the Sault Ste. Marie data to examine exemptions and overages also. We found that overages were not as much of a factor in Sault Ste Marie, since the shoppers tended to make more frequent, but smaller cross-border purchases. In addition, the forms filed in Sault Ste. Marie often did not contain a description of the goods being included in the exemption or overage.

Based on our experience to date, we believe the Thunder Bay data, as shown in Table 3, is representative of the types of goods being purchased by the cross-border shopper that we are most interested in for the purposes of this study: the person who travels more than a few miles to buy a mix of regular consumer goods.

TABLE 3
Overages as Shown On
B-15's Filed in Thunder Bay
Ranked By Number of Occurrences (Trips)

Ranking	# Trips	Description
1	128	clothing
2	47	household electronics
3	36	toys
4	29	housewares
5	22	linens
6	20	tools
7	17	footwear
8	15	lamps & fixtures
9	14	building supplies
10	12	food

We also briefly considered the Statistics Canada weighting of commodities (within the goods and services classification), used in calculating the CPI. Items in this grouping which receive the highest weighting include automobiles, furniture, household appliances, women's sportswear, food and electricity, but this did not appear to us to be a suitable alternative for use because it paid no attention to cross border issues.

After consultation with ISTC, it was determined that the product categories which should be examined as part of this study should be clothing (women's sportswear), household electronics, and bedding and linen. These categories appear to reflect a spectrum of issues of which ISTC is aware based on contact with their client community.

2.4 Our Approach

The research conducted for this study was comprised of both secondary and primary research initiatives. The secondary research program involved scanning various databases as well as contacting a number of institutions and agencies which might have had relevant material.

The primary research program was based upon telephone interviews with key buyers and sellers throughout the channels selected. We contacted more than 80 industry participants to complete 33 successful interviews. This number of contacts was necessary due to the reluctance of interviewees to share specifics of their cost and margin data, especially over the telephone.

The interviews were conducted with buyers and sellers as required at the retail, distributor and manufacturer level for three products in each of three different categories of goods. The focus of our interviews were on input/output costs at each step in the channel. Specific attention was paid to volume pricing arrangements for the industry. Additional cost information, where available, was

gathered. Finally, qualitative factors were discussed to explain the data and add insight to the relative competitiveness of the channels.

The interviewees were guaranteed confidentiality as a means of gaining their co-operation. To this end, we do not report the specific brand or model of the products which we investigated nor the sources of specific data which we document. In addition, we did encounter some problems securing the required data from respondents associated with specific products, especially consumer electronics, because of the high degree of price competition and rivalry. Although in some cases it was difficult to investigate a specific brand and model of product, we were able to gain understanding of the specific costs and markups from the aggregate of the interviews. This, combined with our qualitative overview of the industry, provided a wider breadth to our understanding and sound overall conclusions.

2.5 Secondary Research Methodology

As part of this study, a comprehensive review of secondary sources was undertaken to identify and obtain research reports on the competitiveness of distribution channels in Canada. The primary focus of the research initiative was to identify any comparisons of the competitiveness of Canadian, U.S., or North American distribution channels. Also requested was comparative information about the structures of distribution channels on an overall basis, or for specific industries, particularly those being examined in this study. In addition to the comparative data, we explored the availability of any information about the structure of distribution channels in Canada or the United States. Finally, information about the effectiveness, efficiency or competitiveness of the various elements within distribution channels, either specific to one channel or across channels and industries, was sought.

Database searches of Canadian, U.S. and international publications were conducted, including general and business databases, marketing databases, and an academic dissertations database. We also contacted, by telephone, 36 individuals with various government organizations, industry associations and other research institutions in both Canada and the United States, in search of such information. A list of the organizations contacted in the course of this study is contained in Appendix A.

Relevant Statistics Canada and U.S. Bureau of the Census data has been examined as part of this study, in an attempt to develop a comparative outline of the structure of the wholesale and retail industries in Canada and the United States.

2.6 Researching Consumer Electronics

We completed 12 interviews with consumer electronics industry participants with representation from the major distribution channel members. These included representatives from the various retail chains, independent distributors and distribution subsidiaries. Given the intense rivalry and cut-throat competition in the market, none of the participants was willing to provide all the details included in the questionnaire. Nonetheless, we were able to develop an understanding of the industry structure and issues from the aggregate responses of interview participants. As we determined early in our investigation, there were few audio and video products that were offered in both Canada and the U.S. across all distribution channels, and even fewer industry participants willing to talk about specific margins on specific products.

As a result, our interviews focussed more on aggregate product categories i.e. audio and video products because industry participants told us that, for the most part, products in these categories were distributed and priced in similar ways. In the interviewees' opinions, this was the most meaningful segmentation that participants would be willing to discuss. As a consequence of conducting these interviews at a product category level rather than a product specific level, the reported results are broader in range and are more widely generalizable to most audio and video consumer electronics. Research into relevant issues for the other two product categories was more straightforward.

2.7 Researching Bedding and Linen

We completed nine interviews with bedding and linens industry participants with representation from the major distribution channel members. These included representatives from independent retailers, mass merchandisers, department stores, independent distributors and distribution subsidiaries. We were able to gain more understanding of the competitive nature of the Canadian market than the U.S. market because fewer U.S. firms were willing to fully cooperate in the study. This is, at least in part, due to the U.S. knowledge that many Canadians are cross-border shopping for their bedding and linens in the U.S. and that the Americans are not keen on doing anything that might potentially impact these product sales. Nonetheless, we were able to assemble a reasonable picture of the distribution and margin structure of both markets from the aggregate responses.

2.8 Researching Women's Sportswear

We completed twelve interviews with women's apparel industry participants with representation from the major distribution channels. These included representatives of specialty retailers, department stores, agents, distribution subsidiaries, direct sales, domestic manufacturers, importers and contracting manufacturers.

3. CHANNEL COMPETITIVENESS

3.1 Findings of Secondary Research

Comparative Channel Analysis

Our research identified the existence of some comparative information. A number of studies have been conducted by the Canada Ports Corporation as well as one by the Halifax-Dartmouth Port Development Commission, into the competitiveness of the container shipping and related industries in Canada. The results of these studies have not been publicly released, although a semi-public version of the latest study may be released within the next two to three months. An annotated bibliography of major studies identified by this study has been prepared and is included in Appendix C. No other detailed comparative studies of the competitiveness of the Canadian distribution channels have been identified.

The Industry Profiles, prepared by Industry Science and Technology Canada in 1988, address the overall competitiveness of the retail and wholesale industries in Canada. Both industries were said to be progressive and to compare favourably with its counterparts in the United States. The wholesale industry and large retailers were felt to have the resources available to meet the challenges confronting them, although smaller retailers were thought to face greater difficulties. The Canada-U.S. Free Trade Agreement was expected to have a favourable impact on both industries, by broadening sources of supply, facilitating the freer flow of business innovations and encouraging competition. Channel-specific issues were not addressed in the analyses.

While no comparative studies of the structures of distribution channels in Canada or the United States appear to have been done, one study is currently underway which could conceivably lend itself to this type of analysis. Phase 1 of *The Physical Distribution Study*, currently being conducted by the Ontario Furniture Manufacturers Association, documents the structure of distribution channels within the furniture industry in Canada. This phase is expected to be completed by the end of April. With increasing access to U.S. products, Canadian retailers are encouraging the furniture industry in Canada to attempt to make the cost of delivering Canadian product more competitive with U.S. rates. Phase 2 will address the structure of distribution channels in the United States, and Phase 3, international channels.

One government official suggested that the lack of overall research to date might be due to the fact that it is generally assumed to be the case that Canadian channels are composed of more layers, and thus add higher costs to the final product. The fact that channel structures can differ within industries, between products, and vary over time may also be a factor. Current changes in the structure of distribution in North America, as a result of the Free Trade Agreement and the increasing north-south flow of goods, may provide an incentive for other industries to address the issue on an industry-specific basis in the near future.

Distribution Efficiency and Effectiveness

We have also identified a number of studies and articles which deal with competitiveness of various elements of distribution channels in Canada and the United States, both channel specific and across channels and industries. These include articles on marketing effectiveness, such as *Channel Management is General Management;* logistical efficiency and effectiveness, *High Cost of Direct Sales Spurs Strong Partnerships;* changing technology, *The Technology Maze in*

Wholesale Distribution - choosing the Right Path; and studies of the relationships between buyers and sellers in the apparel industry, *Canadian Retail Apparel Buyers Image and Awareness Study.*

Several key issues arise from a review of this information. Although not a new phenomenon, there seems to be continued movement away from manufacturers' direct sales forces, toward a greater use of independent distributors. At the same time, there is a growing awareness of the need for multiple channels of distribution, and the skills required to manage the various channels. Larger-sized distributors believe that acquisitions continue to be important to their future success, while medium-sized distributors have become more active in the acquisitions area. Major concerns of distributors include competition in the industry and increasing pressure on margins.

Industry Specific Issues

In addition, our secondary research efforts have provided some clues as to the activities of industry, within the three product categories under study, with regard to improving channel management. Some company-specific information was obtained through the database searches, as well as some more general, theoretical information. Almost all of the articles identified were U.S., thus the following information pertains to U.S. activity. Examples of company-specific information generated includes the following:

- in 1989, Sony announced that it would stop using distributors for its consumer electronics, opting for direct distribution as a result of changes in the retail environment and the need for more efficiency and effectiveness;

- for several years, discounters and other value-driven merchants had been cutting into the department store and specialty home fashion business, and are now a dominant outlet - a result of the introduction by leading mills of fashion-oriented products that sell at mass market prices, and the increasing uniformity of U.S. consumer preferences; and

- to overcome difficulties with the retail industry in 1989, sportswear companies implemented new strategies including narrowing distribution channels and working with outlets on displays; offering the retailer a broader range of products; launching special size divisions; continuing licensing efforts; being more responsive to the retailer's and the consumer's needs by delivering merchandise at more frequent intervals; maintaining low inventories; cutting overhead and operating more efficiently.

Information about companies within given industries can provide clues about industry efforts, but these examples should be treated at specific instances rather than definitive practice for their industry. For example, in the consumer electronics industry in 1991, Memtek Products announced it would no longer use a direct sales force to sell its expanded audio equipment line, a move opposite to that chosen by Sony.

None of the sources identified contained specific information about channel costs, and no information was provided on industry trends on an overall basis for the channels. Some of the more general articles provided the following information:

- U.S. manufacturers make greater use of independent reps - an estimated 70% of U.S. manufacturers use independent reps rather than their own sales force versus Canada, where relatively large manufacturers have traditionally dominated and only 30% of manufacturers

use independent distributors[1];

- manufacturers should be ready to pay commissions as high as 10% to a sales rep to peddle a "pioneering" product, but for established products, the charge could be as low as 3%[2]; and

- wholesalers in the $25 million through $999 million group are disappearing, due to mergers and takeovers, however the large wholesalers are not interested in taking over small wholesalers, so the composition of that group is remaining stable[3].

Statistical Comparison

Since little comparative analysis appears to have been done to date, we have gathered relevant Statistics Canada and the U.S. Department of Commerce, Bureau of the Census data to provide a basic comparison of the wholesaling and retail industries in Canada and the United States.

The most recent U.S. statistical data documenting the number of establishments, sales by product grouping, etc., is contained in the 1987 census reports. Differences in classification between product category groupings make direct comparison difficult, both between the U.S. and Canada, and between and within the annual and monthly U.S. reports. For example, different versions of the Standard Industrial Classification structure are used in classifying retail establishments in the United States and Canada. Although sales of eating and drinking establishments are included in the U.S. retail data, they are not included in Canadian retail sales. As a result, it was not possible to develop a detailed analysis of sales by product category and establishment type, over time. The data is, however, useful for generating some order-of-magnitude comparisons.

The following two tables document the relative size of the wholesale and retail industries in Canada and the United States. As the tables indicate, the volume of trade per establishment is higher in the United States for both the wholesale and retail sectors. Due to the lack of detail for Canadian manufacturer's wholesale activities, it is unclear whether the agents, brokers and commission merchants category is in fact larger in Canada. The higher sales per establishment noted in this category may be a result of the inclusion of some manufacturer's sales.

Neither country includes wholesale sales by manufacturers whose primary activity is not wholesale trade, in the wholesale industry data. As a result, a substantial volume of total wholesale activity, that which is considered to be a *secondary activity*, is not captured in these reports. In Canada, in 1987, the value of wholesaling as a *secondary activity* was $30.4 billion, reported by 4,667 manufacturing establishments.

As a percentage of total economic activity, represented by Gross National Product / Expenditure, both wholesale and retail represent larger industries in the United States than in Canada. As a percentage of total activity in the United States and Canada, wholesaling represents 55.8% in the former, and 48.2% in the latter. The figures for the retail sector differ only slightly, at 33.0% and 31.7% respectively. It is important to note that retail, as a percentage of total activity, also includes

1 Jerry Zeidenberg, "Tune in to the best distribution channel," *Small Business*, April 1990, p. 43.
2 Jerry Zeidenberg, "Tune in to the best distribution channel," *Small Business*, April 1990, p. 43.
3 Richard Turcsik, "Acquisitions to Drive Wholesaler Growth," *Supermarket News*, Monday February 11, 1991, p. 10.

a portion of the value of those goods which were offered for sale at both the wholesale and retail levels.

A similar analysis can also be conducted of the various types of wholesale activity, which produces some interesting results. Wholesale merchants represented 32.7% of economic activity in the U.S., versus 41.1% in Canada. Agents, brokers and commission merchants accounted for 5.8% of activity in the U.S. and 7.1% in Canada, while manufacturers sales branches and sales offices produced 17.3% of economic activity in the U.S., which is likely larger than applicable figures for Canada, which are not available.

Comparative Wholesale Statistics, 1987

	Canada	U.S.
Wholesale merchants		
Number of establishments	60,537	388,125
Volume of trade ($Cdn millions)	220,008	1,958,677
Volume of trade/establishment ($Cdn millions)	3.63	5.05
Agents, brokers and commission merchants		
Number of establishments	4,005	42,245
Volume of trade ($Cdn millions)	37,727	349,311
Volume of trade/establishment ($Cdn millions)	9.42	8.27
Manufacturers' sales branches and sales offices		
Number of establishments	na	36,310
Volume of trade ($Cdn millions)	na	1,038,423
Volume of trade/establishment ($Cdn millions)	na	28.60
Total Wholesale Trade		
Number of establishments	64,542	466,680
Volume of trade ($Cdn millions)	257,735	3,346,411
Volume of trade/estab. ($Cdn millions)	3.99	7.17

Sources: Statistics Canada, Wholesale trade statistics, Catalogue 63-226 Annual
U.S. Department of Commerce, Bureau of the Census, 1987 Census of Wholesale, WC87-A-52

Comparative Retail Statistics, 1987

	Canada	United States
Number of establishments	222,350	1,503,593
Volume of trade ($Cdn millions)	169,733	1,980,128
Volume of trade/establishment ($Cdn millions)	0.76	1.32

Sources: Statistics Canada, Retail trade, Catalogue 63-005 Monthly
U.S. Department of Commerce, Bureau of the Census, 1987 Census of Retail Trade, RC87-A-52

A number of conclusions can be drawn based on the statistical data presented here. As a percentage of total economic activity, total wholesale trade is a larger industry in the U.S. than it is in Canada. The fairly significant differences in volume of trade per establishment indicate that U.S. operations tend to be larger, and thus presumably more efficient than operations in Canada.

At the intermediary level, wholesalers operate on a smaller scale in Canada than their counterparts in the United States. Wholesale merchants appear to have a larger role in the Canadian economy, although their operations are of a much smaller size. The larger size of Canadian operations indicated at the agent, broker and commission salesman level is likely a result of the lack of Canadian data for the wholesale activities of manufactures. If such detail were to exist, the overall results of the comparison suggest that each segment would be smaller than its U.S. counterpart.

Retail operations in Canada and the U.S. represent almost the same share of total economic activity. Again, however, Canadian operations are much smaller than their U.S. counterparts.

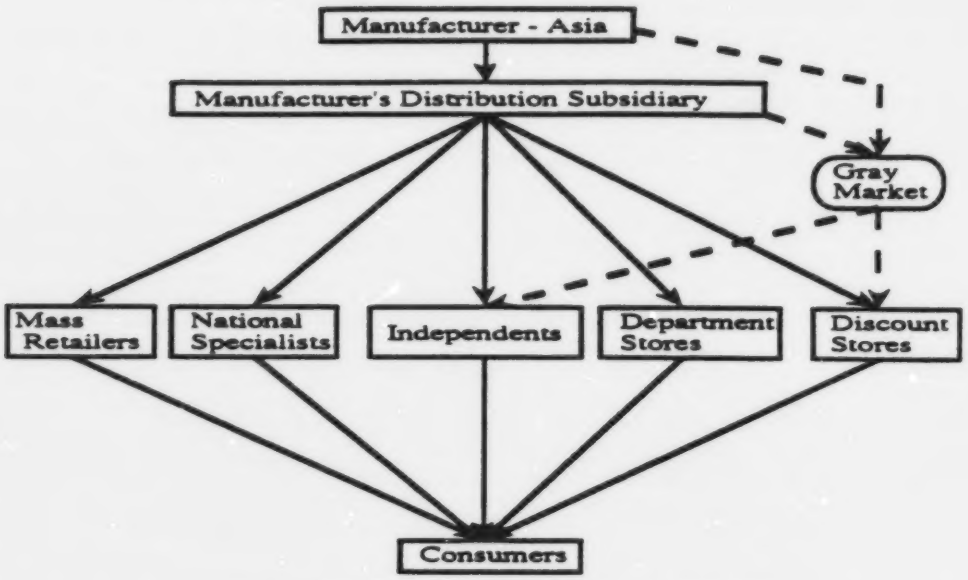
3.2 Findings of Primary Research

As noted, we agreed with ISTC to review three specific product categories: consumer electronics, bedding and linens and women's sportswear.

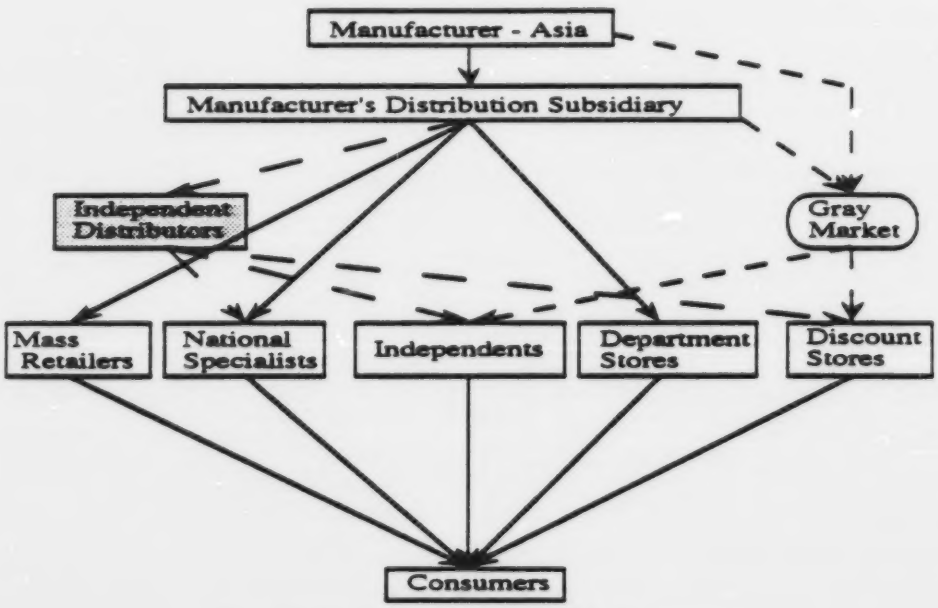
In assessing the channel competitiveness, we examined both interchannel and intrachannel competition. Interchannel competition refers to competition between levels in the distribution channel (i.e. along the vertical dimension) primarily concerned with the relative bargaining power of the different levels. Intrachannel competition refers to competition among participants at a given level in the channel (i.e. along the horizontal dimension) and is primarily determined by costs and pricing policies among channel members.

The specific details of our analysis for each product category follow.

4. Consumer Electronics



For Major Audio / Video Components



For Minor Audio / Video Components

4. CONSUMER ELECTRONICS

4.1 Channel Member Definitions

There are four major levels in the consumer electronics distribution chain. The great majority of products originate overseas (primarily Asia) with the *manufacturer*. These products are then sold to the U.S. or Canadian *distribution subsidiary* which may or may not be wholly-owned by the overseas parent corporation. From the domestic distribution subsidiary, the products are sold to either *independent distributors* or to large *retailers*. Small or rural retailers purchase their products from the independent distributors.

4.2 Channel Structure

The structure of Canadian and U.S. distribution channels for consumer electronics is similar. Both markets are served by domestic distribution subsidiaries that handle importation and domestic distribution of audio and video products. These subsidiaries may be wholly-owned by the parent manufacturer or joint ventures between Canadians or Americans and the parent company. For the most part, the Canadian and U.S. distribution subsidiaries are the only (legitimate) source of supply for each brand, although the gray market does play a role in certain product categories. Both markets are sharply polarized between retailers who deal direct with the distribution subsidiaries and smaller retailers who rely on independent distributors for their products. Both markets are served by 5 major types of retailers:

Retailer	Store Examples
• Mass Retailers	• Canadian Tire, A.M. & A's
• National Specialists	• Majestic, Silo
• Department Stores	• Hudsons Bay, Sears
• Discount Stores	• Stereo City, ElectronicsWarehouse
• Independents	• A local supplier

Mass Retailers, National Specialists and Department Stores usually deal directly with the distribution subsidiary for major products, but minor products are often sourced from independent distributors. Discount Stores and Independents usually source both major and minor products from independent distributors. (Major products would include most high value goods such as VCR's, TV's and stereos while minor products would include items such as tapes, head cleaners, microphones and most audio or video accessories). There are two types of independent distributor in each market; the 2 or 3 national independent distributors who provide small and rural channels with competitively-priced products; and the local independent distributors who provide quick order turnaround and delivery in return for higher margins.

While the Canadian and U.S. markets are similar in structure, the dominant retailers differ. The Canadian market tends to purchase most products through the Mass Retailers and Department Stores for the majority of consumer electronics products, while in the U.S., the National Specialists and the Mass Retailers account for the most product volume. The retail channels which are showing the most growth in both Canada and the U.S. are the Mass Retailers and Warehouse

Clubs, which are a segment of Discount Stores. Both of these retailers are capturing a larger share of the consumer electronics distribution through aggressive pricing and increased market awareness.

4.3 Product Lines

It appears that approximately a third of consumer electronics manufacturers offer exactly the same product to the Canadian and U.S. markets and two-thirds offer distinct products. The manufacturers who offer some of their products to both markets (e.g. Sony, RCA, etc.) not only have products that are certified both by CSA and UL, but some have gone so far as to print one side of the box in French for all North American-bound shipments. Similarly, the internal packaging, warranties and instructions are all printed in English and French (and some are also printed in Spanish). It is believed that over time more identical products will be offered in both markets by these manufacturers and others.

Both the U.S. and Canadian market tend to carry similar products, although there are a number of significant differences between the markets. One major difference is in the timing of product introductions. The U.S. market tends to be the first to receive new products. Canada and the other subsidiary companies tend to lag these new product introductions by a number of months. In addition, the Canadian subsidiary often chooses not to carry the full width and depth of a particular product line, but rather concentrate its volumes in a few product selections from the line. In this way, Canadian retailers offer less selection to consumers but are able to offer these products at lower prices than if they carried the entire product line.

Canadian and U.S. retailers also differ in their branding strategy. In Canada, there are relatively more private label or house brands than in the United States. U.S. consumers appear to be more brand name aware, even for relatively minor brands, than Canadians. Thus while many of the comparable products available in the U.S. are available in Canada, they are only offered under a private brand name. There are a number of possible explanations for this difference. A portion of this discrepancy may be due to the relative strength of department store retailers in Canada versus the U.S. There may be advertising synergies and reputation assumptions that result from private branding. A further reason may be a conscious decision to not offer products in Canada that are directly comparable to products offered in the United States or directly comparable to other competitors' brands.

4.4 Industry Perceptions of Cost Structures

Each of the industry participants surveyed was asked to describe what factors they felt contributed most to the difference in cost structures between Canadian and U.S. distribution channels. The factors Canadians mentioned most often as causing Canada's relative cost disadvantages were higher levels of taxes (federal and provincial levels), higher land costs (high cost of comparable real estate), higher wages (10 - 15% wage premium over U.S. workers), and government regulation (including CSA approvals). Americans were for the most part unaware of specific cost differences but firmly believed that all costs were higher in Canada than in the U.S. This is an interesting finding in that it corresponds to the tendency of many Canadians to believe that prices for all things are lower in the U.S., perhaps including cases where this is not true.

4.5 Interchannel Competition

To a large extent, consumer electronics channel members do not compete with one another directly. This is the result of an evolution of the industry structure such that the large retailers are now as large, if not larger, than the biggest independent distributors and can negotiate comparable costs and volumes with the distribution subsidiaries. As a result, there are fewer independent distributors serving the smaller retail accounts. However, one area where all industry participants do compete is on margin. Margins on consumer electronic goods at each level of the distribution chain are coming under extreme pressure due to the fierce price competition at the retail level. This retail competition has compressed margins at all levels of distribution with each participant trying to secure volumes and market share. This situation is further intensified by the dominance of a few large retailers which tend to be "price leaders" in their markets. In the U.S., these retailers are Silo, Circuit City and a few other national electronics specialists. In Canada, this leadership role is taken by the mass merchandisers, particularly firms such as Canadian Tire and other nationwide firms with high volumes.

4.6 Intrachannel Competition

The level of intrachannel competition is perceived to be increasing at the retail level, not only between retailers in each country but also between Canadian and U.S. retailers. The current recessionary environment has decreased the public's willingness to purchase consumer electronics and because of this, price competition at the retailer level is very intense. Furthermore, the consumers who are willing to purchase electronics are being more price conscious for quality brand name goods. This has led to the relative increase in market share of the discounters, and especially the warehouse clubs, at the expense of the independents and the department stores. Some U.S. retailers have targeted Canadian consumers for their marketing efforts and this has negatively affected Canadian consumer electronics retailers in South-West Ontario. In addition, there is the perception that there is some over-saturation of the Canadian and U.S. consumer electronics markets in this area and the belief that "some of the weaker players may get shaken out of the industry". (To some extent this is already happening - note the recent demise of NWS Electronics and the 1989 demise of one of the market leaders and pioneers - Crazy Eddie.)

A result of this increased level of price competition is the rise in importance of the gray market as an alternative distribution source. The majority of gray market activity is occurring in Canada, with independent distributors and certain retail chains importing electronic goods from the U.S. and directly from Asia (to a limited extent). The gray market activity in the U.S. generally consists of products which have been imported directly from Asia, which may or may not have the necessary government certifications.

4.7 Margin Summary and Examples

Consumer electronics is a very competitive business with many channel members fighting for market share. That said, extensive quantitative data was not widely available from the channels. In addition, margins vary widely among different consumer electronics products and channel members. As a result, the following numbers represent general margin ranges, rather than specific product margins.

The North American distribution subsidiaries usually markup consumer electronics 20 - 35% over and above their costs (i.e. after transportation and insurance costs, applicable tariffs, taxes and

duties are paid). This markup goes to cover the cost of warehousing, administration and overhead as well as generating profits for the distribution subsidiary. This markup may also go toward covering the costs of quality assurance and inspection of the imported products or this service, if required, may be directly charged to the independent distributor or retailer.

Independent distributors usually add a markup of 10 to 30% to their purchase price depending on the services which they are providing to the retailer. In addition to this margin, independent distributors are also eligible for Volume Purchase Rebates and Quick Payment Discounts similar to retailers. These rebates may result in another 7 to 11 points being added to their bottom line.

The largest variance in margin in both Canada and the U.S. occurs at the retailer level between categories of retailer. Although margins vary among retailers in a category (e.g. Majestic Electronics vs. Multitech Warehouse), wider variations in margins occur between categories of retailer (e.g. Discount Stores typically have lower markups than Department Stores.) Depending on the retailer's pricing policies and overheads, they often add a markup of 20 to 40% over their purchase price. Thus depending on whether the product was purchased direct from the distribution subsidiary or through an independent distributor, the price the consumer pays can vary significantly between retailers. For those retailers who purchase products directly from the distribution subsidiary, there are soft dollar incentives in addition to this margin (described below). The four major incentives, their characteristics and their approximate values are;

Type of Incentive	Characteristic	Range of Incentives
Volume Purchase Rebate	Step Function or Straight Line	4 - 7 %
Coop Advertising Allowance	Straight Line	2 - 4 %
Marketing Expenses Rebate	Step Function or Straight Line	1.5 - 3 %
Quick Payment Discount	Straight Line	3 - 4 %
Total		**10.5 % - 18 %**

Note: Step Function refers to bulk discounts that increase as each volume quantity is shipped (e.g. 4% on first 100,000 units and 4.5% on the next 100,000 units), while straight line refers to a fixed percentage at each level (e.g. 4.3% on each unit).

Thus depending on a retailer's willingness to guarantee specific dollar and unit volumes to a given manufacturer, they can receive up to an 18% rebate from the distribution subsidiary that goes directly to the bottom line. (Only retailers that deal directly with the distribution subsidiary are eligible for this rebate, since the 7 to 11% rebates associated with smaller retailers' volumes have already been paid to the independent distributor.) In this manner, "the incentive programs can really "make or break" a retailer's profitability", as one industry source noted.

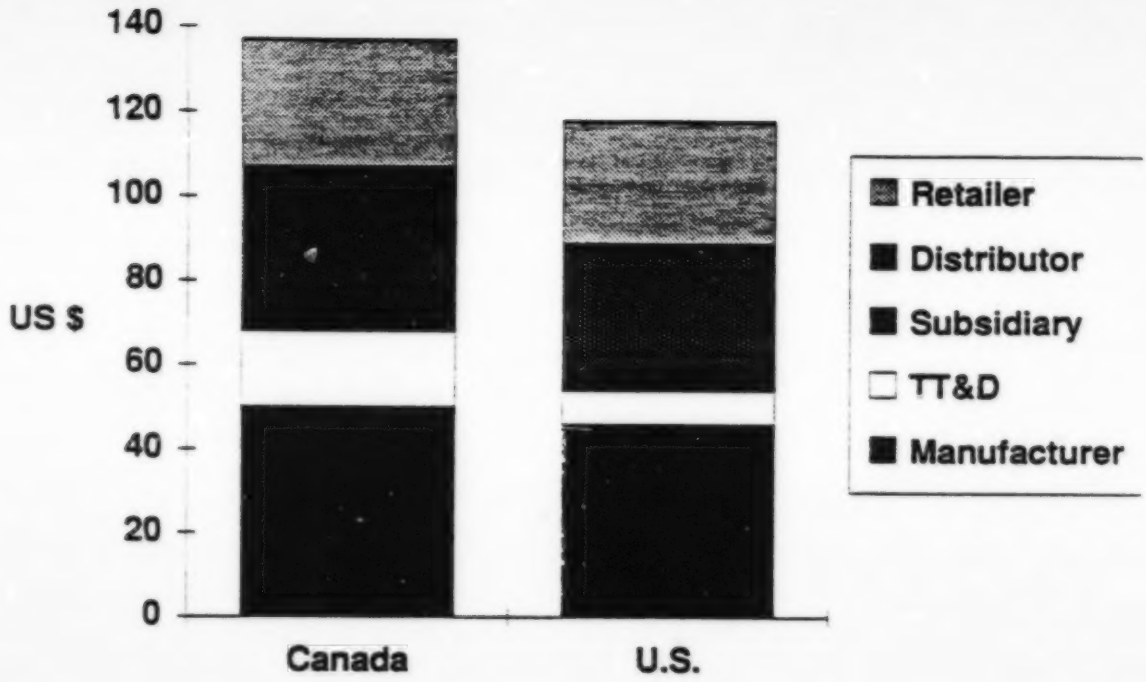
In addition to margins varying by the number and type of distribution channels they pass through, they also vary according to whether the product is audio or video. The average audio product has considerably more margin built in to it than the average video product; often as much as 50 % more markup on a relative basis (i.e. if the average gross margin on video products is 20%, the average gross margin on audio products is 30%.) Industry participants explained that to a certain extent,

video products are seen as necessities (- especially TV's and VCR's), while audio products are seen as luxuries. In addition, the audio market is more fragmented and appears to have relatively more discrete brands, each with their own brand positioning and identity. The audio brands have more perceived differences associated with them than the relatively homogeneous video product offerings.

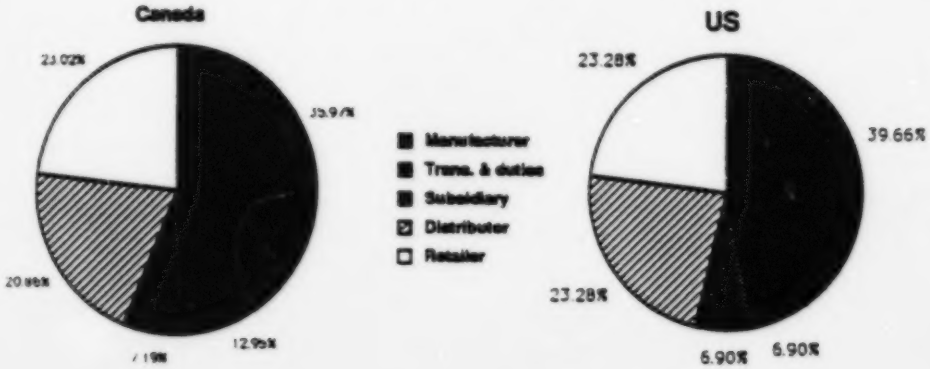
Although the margin and pricing structures are similar in Canada and the U.S., there are two fundamental differences between the Canadian examples illustrated below and the corresponding U.S. equivalents. First, the U.S. market is the largest market for consumer electronics in the world (it is more than ten times the size of the Canadian market, an often-used approximation for market comparison, based on an approximate ratio of population and GNP). As a result of this scale difference and strategic imperative (to be large in the global electronics market, one has to be a significant participant in the U.S.), the price that the U.S. distribution subsidiary is able to negotiate with the parent corporation is often better than the equivalent Canadian pricing. This often accounts for a 5 - 10 percent cost difference. The second key difference is the Canadian examples illustrate the higher taxes and tariffs on consumer electronics as well as the increased costs of double handling, warehousing and transportation.

In summary, the following examples attempt to portray realistic pictures of the margins and prices at each level of distribution for a representative audio and video product. (All cases are described in U.S. dollars).

Case 1 - Via Distributor - Audio



Percentage of Retail Price

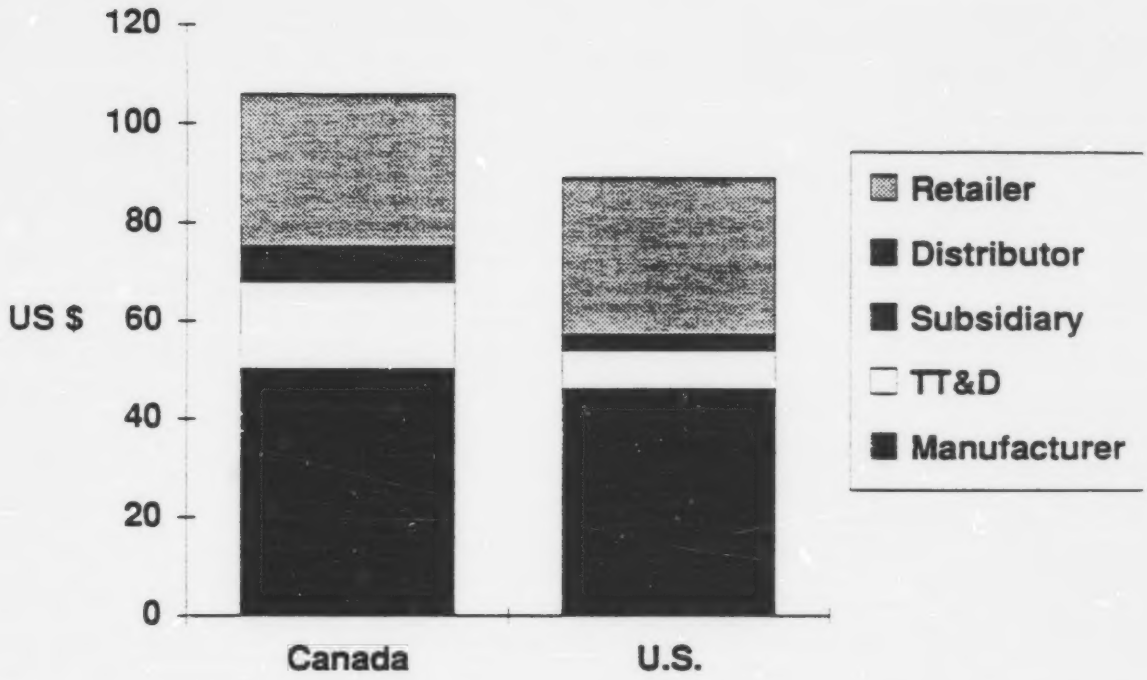


Case 1 - Via Distributor - Audio

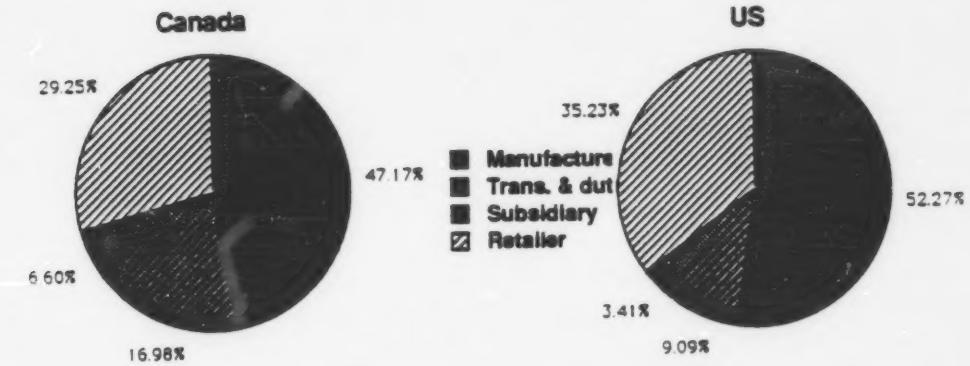
This case examines a representative audio product (e.g. "boom box") purchased from a small retailer who purchased it from an independent distributor. The costs of an additional layer of distribution are reflected in the consumer prices. Also of note are the effects of U.S. volume purchasing with lower prices reflected at every level.

Note: Prices are in U.S. $	**Canada**	**%**	**U.S.**	**%**
Ex-Manufacturer (Asia)	$ 50	100%	$ 46	92%
Transportation Costs	$ 10	20%	$ 4	8%
Tariffs	$ 8	16%	$ 4	8%
Subsidiary Markup	$ 18	36%	$ 16	32%
Less Discounts (if applicable)	($ 8)	(16%)	($ 8)	(16%)
Ex-Subsidiary	$ 78		$ 62	
Distributor (if needed)	$ 21	42%	$ 19	38%
Add Discounts (if applicable)	$ 8	16%	$ 8	16%
Ex-Distributor	$ 107		$ 89	
Retailer (via Distributor) (No Discounts)	$ 32	64%	$ 27	54%
Consumer's Price (U.S.$)	**$ 139**	**278%**	**$ 116**	**232%**
Exchange Rate ($1 U.S. = $1.16 Canadian)				
Canadian Consumer's Price	**C$ 161**			

Case 2 - Direct to a High Volume Retailer - Audio



Percentage of Retail Price

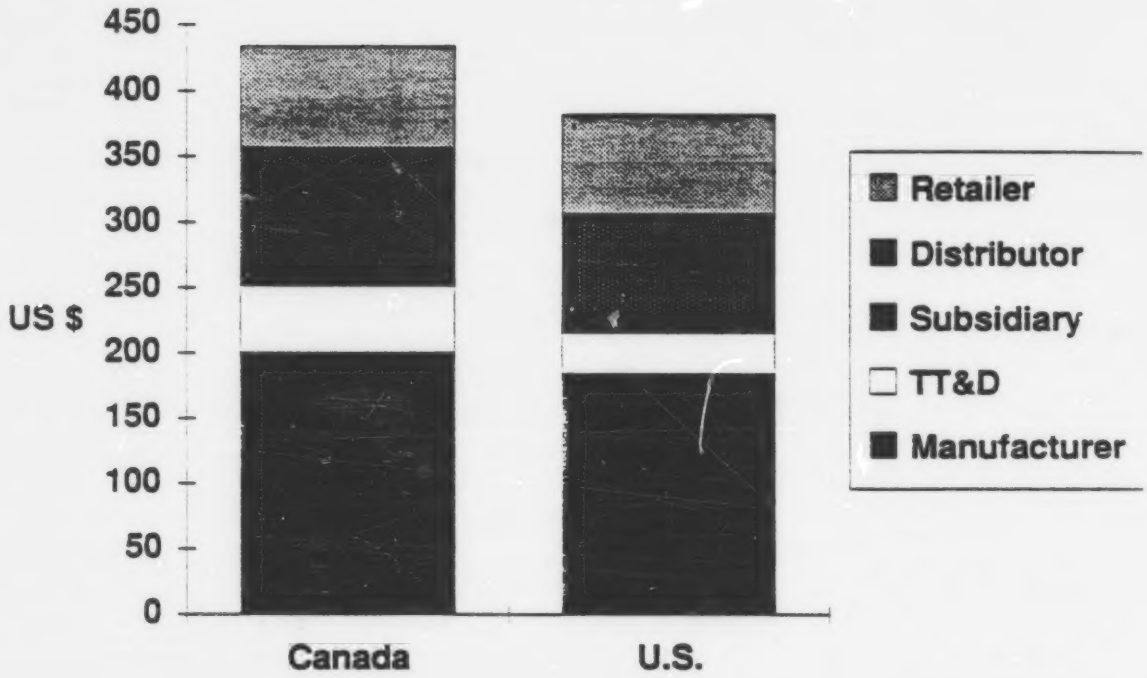


Case 2 - Direct to High Volume Retailer - Audio

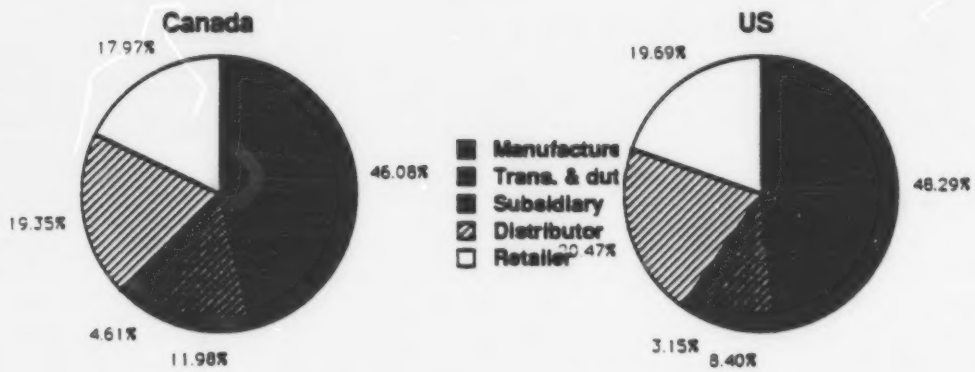
This case examines the same representative audio product, but reflects the difference of one fewer layer of distribution. Also worthy of note is the lower U.S. costs for transport, tariffs and duties as well as the lower markups at each level of distribution.

Note: Prices are in U.S. $	Canada	%	U.S.	%
Ex-Manufacturer (Asia)	$ 50	100%	$ 46	92%
Transportation Costs	$ 10	20%	$ 4	8%
Tariffs	$ 8	16%	$ 4	8%
Subsidiary Markup	$ 18	36%	$ 16	32%
Less Discounts (if applicable)	($ 11)	(22%)	($ 13)	(26%)
Ex-Subsidiary	$ 75		$ 57	
Retailer (High Volume)	$ 20	40%	$ 18	36%
Add Discounts (if applicable)	$ 11	22%	$ 13	26%
Consumer's Price (U.S.$)	**$106**	**212%**	**$ 88**	**176%**
Exchange Rate ($1 U.S. = $1.16 Canadian)				
Canadian Consumer's Price	**C$123**			

Case 3 - Via Distributor - Video



Percentage of Retail Price

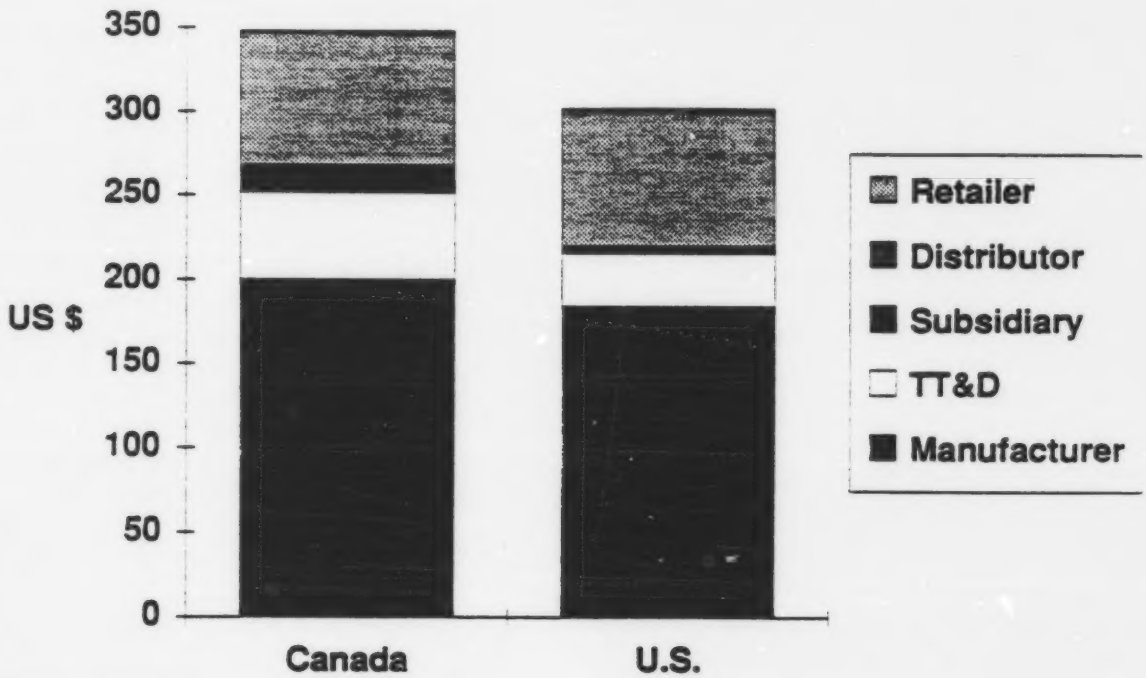


Case 3 - Via Distributor - Video

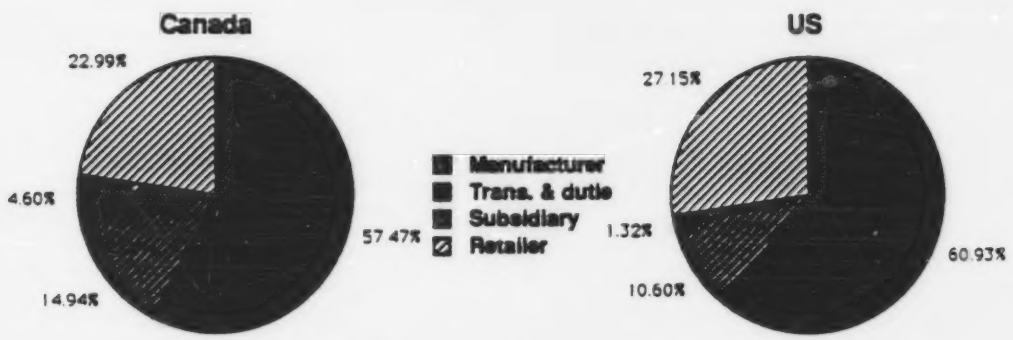
This case is similar to Case 1 in that it illustrates the purchase of a representative video product (e.g. VCR) through a small retailer who purchased it from an independent distributor. The additional layer of distribution adds considerably to the final cost the consumer must pay. This example also illustrates the relative differences in margin between U.S. and Canadian distribution channel members.

Note: Prices are in U.S. $	Canada	%	U.S.	%
Ex-Manufacturer (Asia)	$ 200	100%	$ 184	92%
Transportation Costs	$ 28	14%	$ 16	8%
Tariffs	$ 24	12%	$ 16	8%
Subsidiary Markup	$ 48	24%	$ 40	20%
Less Discounts (if applicable)	($ 28)	(14%)	($ 28)	(14%)
Ex-Subsidiary	$272		$ 228	
Distributor (if needed)	$ 56	28%	$ 50	25%
Add Discounts (if applicable)	$ 28	14%	$ 28	14%
Ex-Distributor	$356		$ 306	
Retailer (via Distributor) (No Discounts)	$ 78	39%	$ 75	38%
Consumer's Price (U.S.$)	**$434**	**217%**	**$ 381**	**191%**
Exchange Rate ($1 U.S. = $1.16 Canadian)				
Canadian Consumer's Price	**C$503**			

Case 4 - Direct to a High Volume Retailer - Video



Percentage of Retail Price

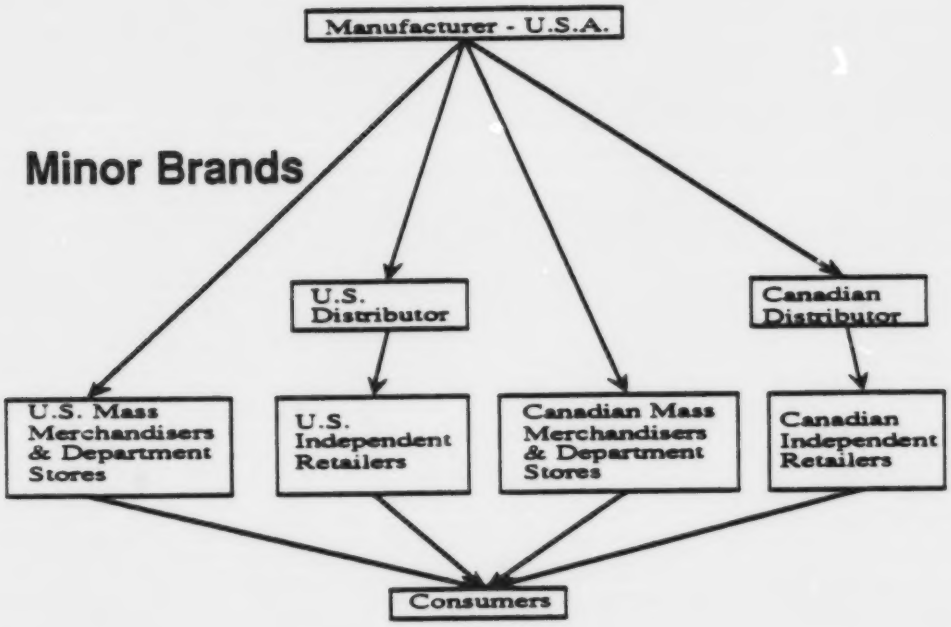


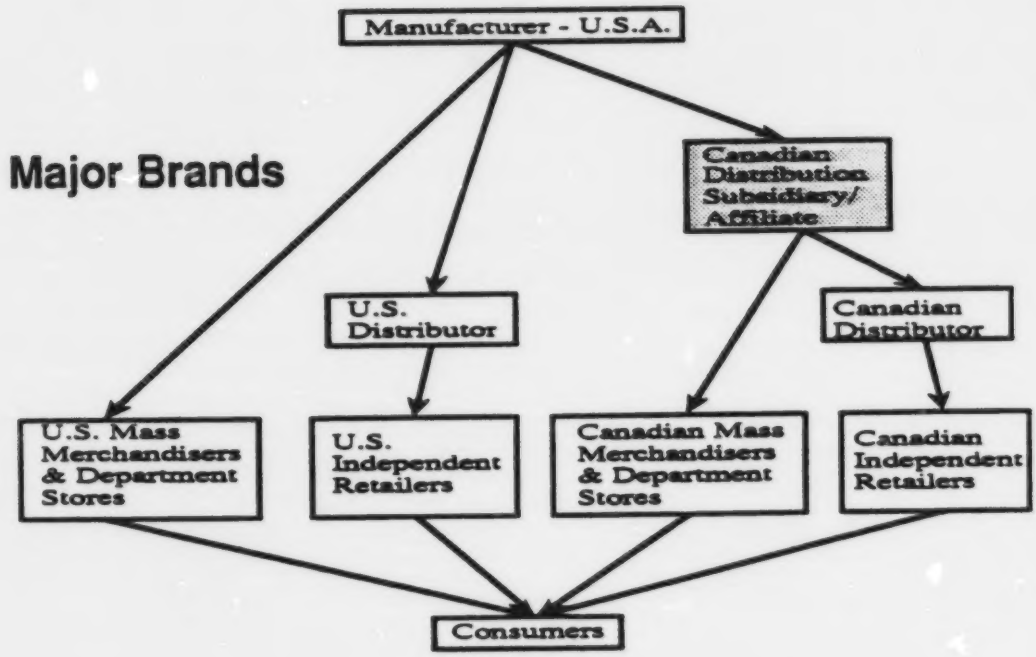
Case 4 - Direct to High Volume Retailer - Video

This example illustrates the same VCR but purchased through a high volume retailer who deals directly with the distribution subsidiary. Note the differences in price at every level of the channel that stem from the volume discounts that the U.S. distribution subsidiary and retailer are able to negotiate.

Note: Prices are in U.S. $	Canada	%	U.S.	%
Ex-Manufacturer (Asia)	$ 200	100%	$ 184	92%
Transportation Costs	$ 28	14%	$ 16	8%
Tariffs	$ 24	12%	$ 16	8%
Subsidiary Markup	$ 48	24%	$ 40	20%
Less Discounts (if applicable)	($ 32)	(16%)	($ 36)	(18%)
Ex-Subsidiary	$ 258		$ 214	
Retailer (High Volume)	$ 48	24%	$ 46	23%
Add Discounts (if applicable)	$ 32	16%	$ 36	18%
Consumer's Price (U.S.$)	**$348**	**174%**	**$ 302**	**151%**
Exchange Rate ($1 U.S. = $1.16 Canadian)				
Canadian Consumer's Price	**C$403**			

5. Bedding and Linen





5. BEDDING AND LINEN

5.1 Channel Member Definitions

There are a number of levels in the bedding and linens distribution chain depending on the size of the buyer and the country of sale. In the U.S., the *manufacturer* sells either directly to the large *mass merchandisers* and *department stores* or to national and/or regional *distributors* who in turn sell the bedding and linens to *independent retailers*. In Canada by contrast, the U.S. *manufacturer* sells its goods to either a Canadian *distribution subsidiary / affiliate* for most major brand name products or direct to a Canadian *distributor* for minor brands. In the case of the Canadian *distribution subsidiary*, they may sell either to the *distributors* or direct to the *mass merchandisers* and *department stores*. The *distributors* in turn supply *independent* Canadian *retailers*. Thus the additional levels of distribution in Canada increase the final cost consumers must pay for the same goods.

5.2 Channel Structure

The structure of Canadian and U.S. distribution channels for "white goods" is very similar at both "the top and the bottom of the distribution pyramid". The goods sold in both markets are extensively manufactured in the U.S. and sold to consumers through either independent retailers or the mass merchandisers / department stores. The differences in distribution channels occur between when the product leaves the mill and it reaches the retailer.

Product distribution in the U.S. is reasonably straight forward with only minor variations in the distribution patterns, while in Canada product distribution is more complex. For the most part, U.S. mass merchandisers and department stores purchase their products in large volumes directly from the mills. Smaller U.S. retailers who do not have the volume of sales to be served by the mills, purchase their products from the distributors. Canadian mass merchandisers and department stores are largely served by the Canadian distribution subsidiary or affiliate with whom they deal directly. However in those cases where a Canadian subsidiary does not exist, Canadians may deal directly with the mills. Smaller Canadian independent retailers purchase products from distributors who will either source these products from the domestic distribution subsidiary or, if one does not exist, then get the products directly from the mills.

Both the Canadian and U.S. markets for bedding and linens are sharply polarized between large retailers who deal direct with the mills or the Canadian distribution subsidiary and smaller retailers who rely on independent distributors for their products. The Canadian and U.S. markets are similar in their polarization and the overall dominance of the mass merchandisers and department stores in these markets. Industry sources estimate that the majority (60 to 80%) of products is sold through mass merchandisers and department stores (Canadian sources believe that the department stores are relatively more important in Canada than in the U.S.). Although other channels exist (discount stores who tend to sell lesser quality products and high end boutiques that tend to sell imported bedding and linens, both of which are not extensively affected by cross-border shopping), they tend to account for small percentages of the overall industry sales.

5.3 Product Lines

Although each of the industry participants we spoke with carries bedding and linen products of U.S. origin, the percentage of sales that U.S. domestically manufactured products account for

varies by type of independent distributor and retailer. As expected, the vast majority (90%+) of bedding and linen products sold in the U.S. are from domestic manufacturers, with some limited penetration of "high end" European manufactured goods (primarily imported from Italy, Germany and the United Kingdom). In Canada, however, there are three distinct product segments, with each segment having a different country of manufacture. The "low end" of the Canadian market is served by Canadian manufacturers who account for 20 to 30% of the Canadian sales volume; the mid-priced market is served by the U.S. manufacturers (30 to 60% of Canadian sales); and the "high end" is served by the European manufacturers (sales of 10 to 20%). The bedding and linen products that are the most affected by cross-border shopping are those of U.S. manufactured origin.

Although the identical products from the same manufacturer are available in Canada and the U.S., the range of available products (product line width) varies. In almost all cases, it appears that the Canadian market demand is aggregated with the U.S. demand and included in the same manufacturer's production run (since economies of scale are very important). Based on the production volume, the products are then allocated to the various regions depending upon their requested volumes. In some cases, Canadian firms find that their requested volumes for individual products are unmet (often due to the small size of the particular order). This situation is further compounded at the re-order point, where Canadian demand for a particular product must wait until U.S. re-order volumes justify scheduling a production run. As a result of these two factors, the width of the available product line for bedding and linens is often narrower in Canada than in the U.S.

5.4 Industry Perceptions of Cost Structures

Each of the industry participants surveyed was asked to describe what factors they felt contributed most to the difference in cost structures between Canadian and U.S. distribution channels. The factors Canadians mentioned most often as causing Canada's relative cost disadvantages were the Canadian import tariffs (currently 17.5% but decreasing with implementation of the Free Trade Agreement), the double handling, warehousing, and distribution functions performed by the distribution subsidiaries, and the additional labelling necessary for the Canadian market (bilingual and additional care/content requirements).

5.5 Interchannel Competition

Bedding and linens channel members do not directly compete with one another for the most part. This is largely the result of the polarization at the retail level between small independent retailers who do not have the volume necessary to deal directly with the manufacturer or distribution subsidiary and the mass merchandisers and department stores that will only deal directly with them.

This situation may change over time as barriers between markets decrease and price competition increases. Through increased cross-border shopping, awareness of the relative price differentials for bedding and linens is increasing as well as the expectations that as the tariff structure is rolled back under the Free Trade Agreement, prices in Canada should align themselves with current U.S. prices. As a result, the mass merchandisers and department stores may begin to deal directly with the manufacturer. Similarly, independent retailers may begin dealing with U.S. distributors for their product supply. The result of such an evolution of the industry structure will fundamentally change the roles, relationships and the level of interchannel competition in the future.

5.6 Intrachannel Competition

Unlike other product categories where intrachannel competition is based almost exclusively on price, intrachannel competition among bedding and linen channels occurs along three dimensions: price, selection and quality. While price is still important to the end consumer, there is less emphasis on pure price comparisons between retailers. This is, at least in part, due to the available product selections that each retailer carries and the difficulty in comparing exact articles between retailers (e.g. available sizes - twin, double, queen, king, colours and brands). While there are some consumer segments that are very price sensitive, many consumers put a great deal of influence on product quality (e.g. fabric type, thread count, etc.). This competition along three dimensions, tends to lessen price competition and improve margins for all retailers. (However, one retailer commented that he gets significantly more product inquiries when he runs a promotional sale at reduced markups.)

5.7 Margins

Margins vary slightly among different bedding and linen products (sheets, pillowcases, towels etc.) depending upon their price range but vary significantly among different retailers and whether they are being sold at regular or promotional prices. As a result of this wide variance, the following numbers represent typical margin ranges for bedding and linens, rather than specific product margins for individual sizes and styles of sheets and towels.

Margins vary by level in the distribution chain and whether the chain is in Canada or in the U.S. The manufacturing mills operate as profit centres and include a small percentage markup (approximately 10 - 20%) in their selling price. U.S. mass merchandisers and department stores as well as the Canadian distribution subsidiaries purchase directly from the mills and then add their markups. Since the largest difference is between Canadian and U.S. channels, these will be detailed separately in the following sections.

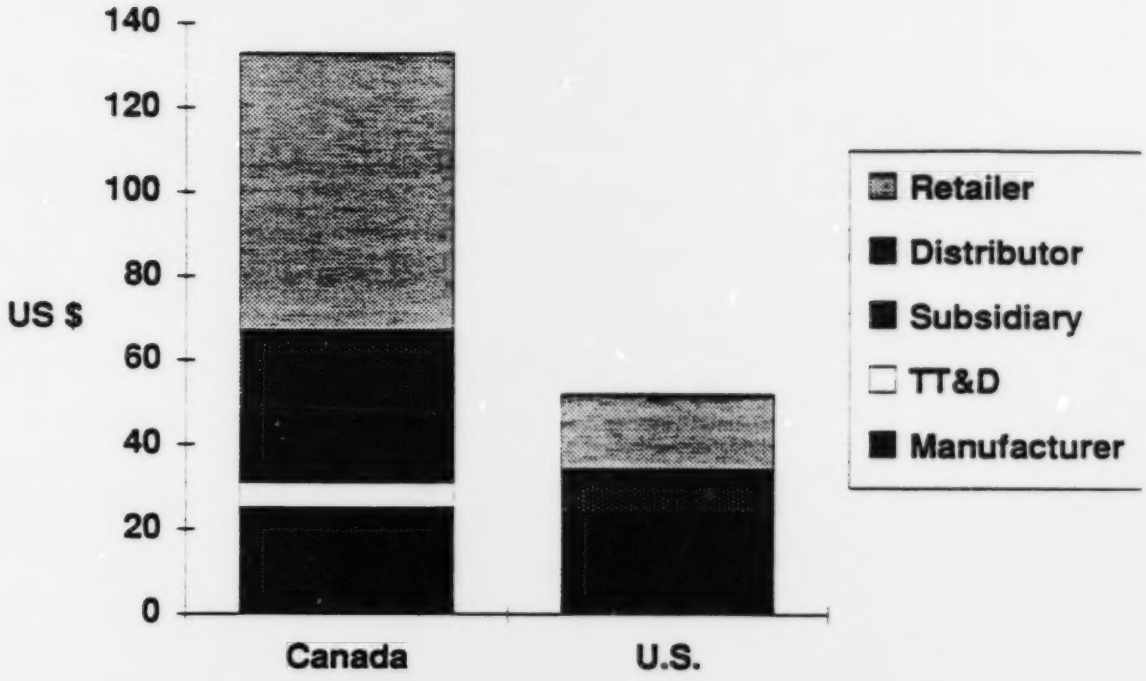
5.8 U.S. Distribution Channels and Margins

U.S. mass merchandisers and department stores that buy bedding and linens directly from the mills markup these products approximately 40 to 60% over the cost that they buy them for. Included in this markup is the store's operating, administrative and overhead costs. U.S. distributors purchase these products for the same price as the major retailers, however their margins tend to be lower than those of the retailers. Distributors' markups are in the 30 to 40 percent range. The distributors sell their products to the independent retailers who typically mark them up by another 30 to 50%.

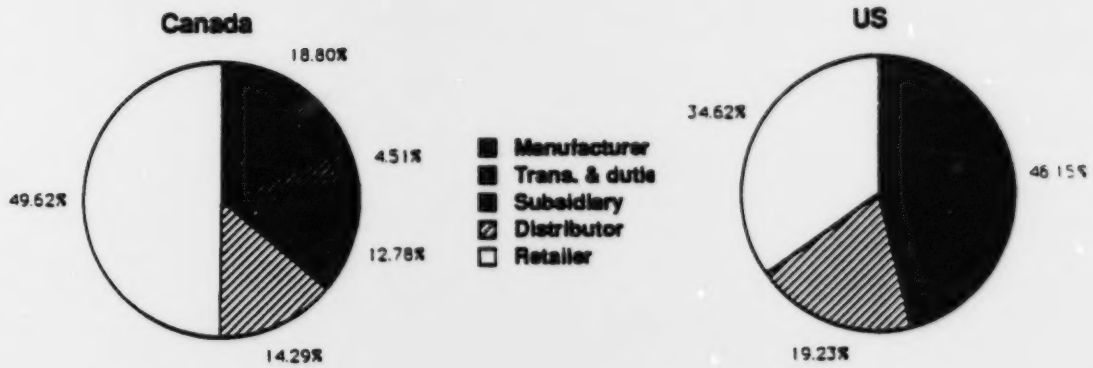
5.9 Canadian Distribution Channels and Margins

Canadian channel members tend to have higher prices at each level. The Canadian distribution subsidiaries usually markup bedding and linens by approximately 100% (i.e. they double the price they purchased the goods for). Although these distribution subsidiaries are operated as profit centres, not all of this revenue is profit. From this revenue, currency exchange costs (16 - 20%), tariffs (17.5%), transportation and brokerage costs (3 - 5%), as well as additional labelling costs, operating, warehousing, administrative and overhead costs must be subtracted. The remainder is the subsidiary profit. The distribution subsidiary, in turn, sells its products to the Canadian mass merchandisers, department stores and distributors. It is at this point that the largest markups are

Case 1 - Independent Retailer Via Distributor



Percentage of Retail Price



added. Some mass merchandisers and department stores double their purchase costs and sell the product to the consumer at this price. Other retailers' markups to get the "regular" retail price are in the 150 - 200% range. Of course, consumer sale prices are calculated as a savings from this regular price. Even among these "regular prices", there is a large degree of variability, in part because many of these products do not have a "suggested retail price". Canadian distributors tend to add markups in the 30 to 40% range and then sell them to independent retailers who add their 50 to 150% markup over their costs.

In some instances, where a Canadian distribution subsidiary does not exist, Canadian mass merchandisers and department stores can purchase directly from the manufacturer at a better price than their U.S. counterparts. This is due to the fact that, for the most part, there are not the marketing incentives that exist in other industries. As a result, some U.S. manufacturers will give Canadian buyers a discount since they do not benefit from the manufacturer's U.S. brand advertising. For products in this category, prices at the consumer level do not vary significantly between Canada and the U.S. As for volume agreements, they often do exist but are usually negotiated "up front" to result in lower purchase costs rather than be structured as "bottom line incentives" as is the case in other industries.

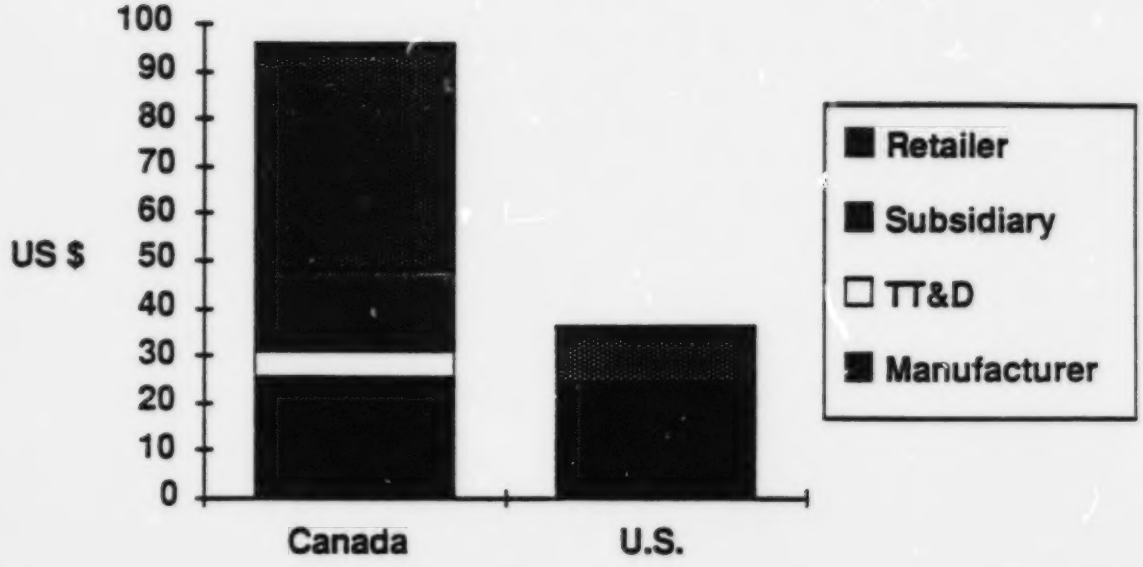
5.10 Margin Summary and Examples

In summary, the following examples attempt to portray realistic pictures of the margins and prices at each level of distribution for a representative bedding and linen product (Brand Name Cotton/Polyester Sheets, 200 Thread Count, Queen Size).

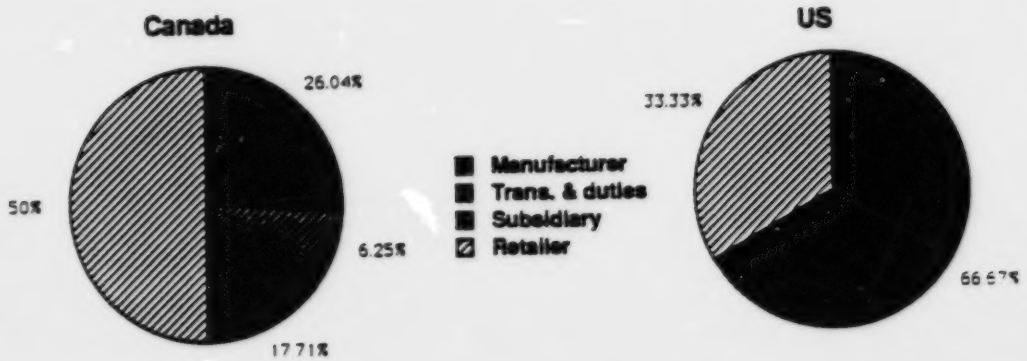
Case 1 - Independent Retailer Via Distributor

This case illustrates the differences between a Canadian consumer paying for two levels of Canadian distribution and an U.S. consumer or cross-border shopper paying for one level of product distribution. Note the extreme differences in price that apply after the distribution subsidiary has added their margin as well as the relatively lower amounts that U.S. retailers markup their products by (53% over their costs versus 100% for Canadian retailers).

Case 2 - Direct to a Mass Merchant or Department Store



Percentage of Retail Price



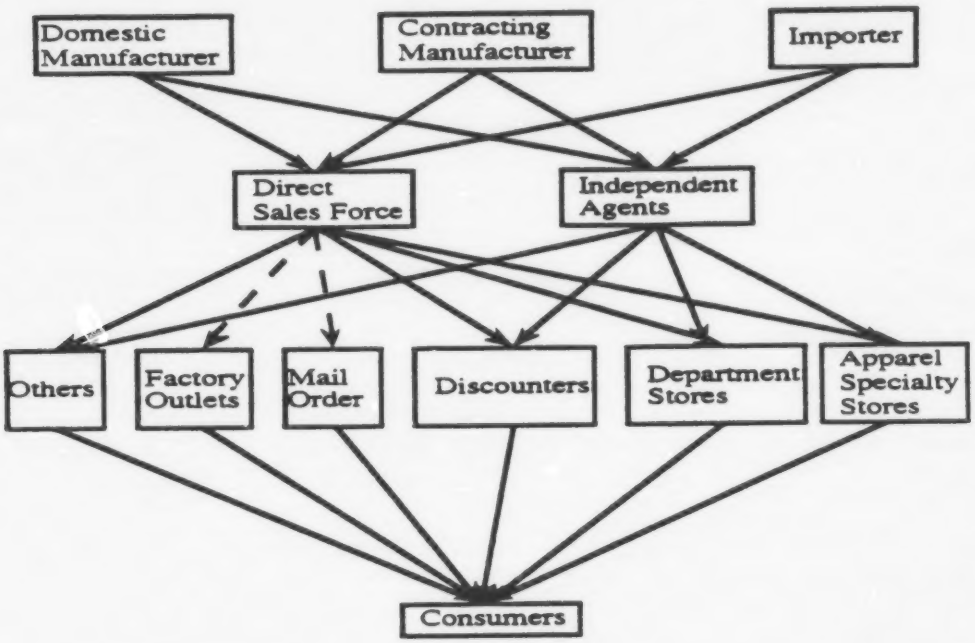
Note: Prices are in U.S. $	Canada	%	U.S.	%
Ex-Manufacturer (U.S.)	$ 25	100%	$ 24	96%
Tariffs	$ 5	20%	$ 0	0%
Transportation	$ 1	4%	$ 0	0%
Subsidiary Costs & Margin	$ 17	68%	$ 0	0%
Ex-Subsidiary	$ 48	192%	$ 24	96%
Distributor	$ 19	76%	$ 10	40%
Ex-Distributor	$ 67	268%	$ 34	136%
Retailer (via Distributor) (No Discounts)	$ 66	264%	$ 18	72%
Consumer's Price (U.S.$)	**$ 133**	**532%**	**$ 52**	**208%**
Exchange Rate ($1 U.S. = $1.16 Canadian)				
Canadian Consumer's Price	**C$ 154**			

Case 2 - Direct to Mass Merchandiser or Department Store

This case illustrates the differences in consumer prices from one level of distribution versus two in the previous example. Together both cases illustrate why bedding and linens are among the most popular cross-border shopping purchases.

Note: Prices are in U.S. $	Canada	%	U.S.	%
Ex-Manufacturer (U.S.)	$ 25	100%	$ 24	96%
Tariffs and Duties	$ 5	20%	$ 0	0%
Transportation	$ 1	4%	$ 0	0%
Subsidiary Costs & Markup	$ 17	68%	$ 0	0%
Ex-Subsidiary	$ 48	192%	$ 24	96%
Retailer (No Discounts)	$ 48	192%	$ 12	48%
Consumer's Price (U.S.$)	**$ 96**	**384%**	**$ 36**	**150%**
Exchange Rate ($1 U.S. = $1.16 Canadian)				
Canadian Consumer's Price	**C$111**			

6. Women's Sportswear



6. WOMEN'S SPORTSWEAR

6.1 Channel Member Definitions

The distribution channels for women's sportswear in Canada and the U.S. are very similar in structure although the relative importance of each channel member differs from Canada to the U.S. There are three types of women's sportswear manufacturers; the *Domestic Manufacturer* (either Canadian or U.S.), the *Contracting Manufacturer* (contracts partial or complete manufacturing to offshore sources from domestic designs, controls and brand names) and the *Importers* (all manufacturing done overseas). There are two major types of wholesale distribution intermediaries; the manufacturers' *Direct Sales Force* (also known as "housemen") and *Agents* who often represent the product lines of 4 or 5 manufacturers. For the most part, the larger manufacturers and/or those serving major urban markets have direct sales forces , while smaller manufacturers and/or those serving smaller markets rely on agents. However, the costs associated with these distribution intermediaries are borne by the manufacturers rather than adding another level of markup as is the case in other product categories. At the retail level, there are six major channels for sportswear distribution; the *Apparel Specialty Stores, the Department Store Chains, the Discounters, Mail Orders, Factory Outlets* and *Other* retailers (primarily grocery and sporting goods stores).

6.2 Industry Structure

The women's sportswear apparel industry is diverse and fragmented. Some industry participants that were surveyed stated that the women's sportswear industry should be regarded as a group of very small markets, each with its own particular characteristics.

Few authoritative statistics exist with respect to channel structure, size or segmentation and individual industry participants tended to know their market niche very well but did not have a sense for the overall industry. As a result, the comments presented are specific to particular products, manufacturers and distribution channels. Each fragment or niche in the industry has its own set of competitors and margins, so caution should be used if using these data for generalizations. (For example, in the category of women's blouses, there are literally hundreds of quality and design sub-segments, each with its own competitors, margins and price points.) In general, there are five main price points that are used in the trade. These are (in ascending order); budget, popular, moderate, better and designer.

In addition, it appears that many of the women's sportswear brands available in Canada are not available in the U.S. and vice versa (i.e. although comparable products exist, the exact brands differ). Part of the reason for this appears to be the relative domination of the leading brands in the U.S. market when compared to the Canadian market. Furthermore, it should be noted that even when identical brands of product are available on either side of the border, they are not necessarily manufactured at the same source. This can result in large price differences between markets.

6.3 Channel Structure

The structure of Canadian and U.S. distribution channels for women's sportswear are the same. As previously noted, manufacturers fall into one of three categories based upon where the majority of their manufacturing takes place, product distribution is done by the manufacturer's direct sales force or agents, and retail distribution flows through one of six categories of retailer.

However, there are significant differences in the relative importance of the distribution channel members between Canada and the U.S. In the U.S., more of the market is served by domestic manufacturers, while in Canada a larger proportion is served by contracting manufacturers. It is believed that this is the result of higher wages and fabric duties in Canada and the U.S. access to its domestic sources of cotton. In Canada, apparel specialty stores control the majority of sales volume (approximately 40 - 45%), while in the U.S., department stores control more of this volume (approximately 40%). In addition, Canada has relatively few factory outlet operations when compared to the U.S. One possible explanation for this absence is the Canadian manufacturers' dependence on relatively fewer retailers for their volume and as a result, mindful of the perception that the manufacturer is competing against its buyers by forward integrating into a factory outlet store. For some sportswear retailers, this appears to be more of an issue than it is in other sectors. Another under-developed area of Canadian retailing is the mail order business. This is, at least in part, due to the relative higher prices for postage in Canada.

6.4 Product Lines

Although there are a number of ways to segment the women's sportswear industry, one of the most widely used methods is to segment by price. The five pricing categories mentioned above (budget, popular, moderate, better and designer) can be used to approximate a segmentation of products available from manufacturers. At the designer end of women's sportswear, the majority of products are imported from Europe (primarily Italy and France) by independent importers. Women's sportswear in the better and moderate categories may be manufactured in Canada, the U.S., Europe or Asia depending upon the specific product category and brand name. Goods in the better and moderate categories may be manufactured by domestic manufacturers, contracting manufacturers or importers. Women's sportswear products in the budget or popular price categories tend to be manufactured either in part or in total overseas and brought into Canada by importers or contracting manufacturers. In many cases, these items become the private brands of the major Canadian and U.S. retailers and in general there is little cross-border shopping for these lower end items. Much of the cross-border shopping is done for either women's sportswear that is manufactured in the U.S. or overseas under contract for particular designers and sold directly to the major Canadian and U.S. retail chains. In this way, some cross-border shopping is driven more by perceived value for money spent, rather than simply to save money (i.e. some cross-border shoppers who might normally purchase women's sportswear at budget or popular price points are more likely to purchase sportswear at moderate or better price points and given the differences in markups between Canada and the U.S. are likely to spend the same amount of money that they would have spent in Canada for goods of lesser quality).

As well, a large proportion of cross-border shopping for women's sportswear that takes place is for products that are in the moderate, better or designer price points. The driving force behind this cross-border shopping is often the ability of a person who usually purchases clothing at moderate price points to suddenly be able to afford better or designer clothing for the same dollars. This increased "purchasing power" is largely due to the more developed role of the discount retailer among U.S. retailers.

Another reason for this cross-border shopping for women's apparel is the increased width of the product lines and that many Canadians perceive U.S. retailers to carry a wider product selection (e.g. more colours, in more styles than comparative Canadian retailer chains). Similar to the experience of the bedding and linen industry, we found that the Canadian market demand is often aggregated with the U.S. demand to be included in the manufacturer's production run. As a result, the problems of short-shipping, re-order quantities and a geographically diverse market affect the

relative available product line width for women's sportswear in Canada.

6.5 Industry Perceptions of Cost Structures

Each of the apparel industry participants was asked to describe what factors they felt contributed most to the difference in cost structures between Canadian and U.S. distribution channels. The factors Canadians mentioned most often as causing Canada's higher prices were the Canadian import tariffs on U.S.-made goods (currently 16.25 to 17.5% depending on the article of apparel), the higher relative level of competition among U.S. retailers and their acceptance of lower margins and the higher costs of doing business in Canada (cited examples include higher labour rates, taxes, government "red tape" and rents and other real estate costs).

6.6 Interchannel Competition

Unlike the other two sectors which we examined in this study, there is a large amount of interchannel competition in the women's sportswear market, particularly in the U.S. market. At one level, the three types of manufacturers compete against the agents for the right to represent a particular product line in a particular country. Depending on the anticipated success of a particular line of women's sportswear in a particular market, the foreign manufacturer may decide to supply the market by selling the product to an importer or contracting the product manufacturing to a domestic manufacturer or delivering the products directly to the retailer using an agent to close the sale. At another level, the manufacturers may compete with the retailers through the manufacturer's forward integration into factory outlet stores or mail order catalogues. (Although this depends on the factory outlet's purpose i.e. sell first quality merchandise at a significant discount or use it as a clearance outlet for sub-standard merchandise.) At another level, importers compete against agents for the opportunity of representing a particular product in a particular market.

6.7 Intrachannel Competition

As one might expect, there is a large amount of intrachannel competition for women's sportswear products. The manufacturers compete against one another for the right to manufacture a particular line. This competition is often based on three dimensions; price, quality and control. Depending upon the price point for the particular women's sportswear product, these criteria vary in importance. Domestic manufacturers have a reputation for providing high quality work under strict controls but are also more expensive than the other two types of manufacturer. Contracting manufacturers are the most flexible in that they can use domestic manufacturing to provide high quality work where necessary (i.e. for garment finishing) but utilize foreign manufacturers to do the internal or rough fabrication. They tend to be less expensive and less controllable than the domestic manufacturers. Importers can source products at either end of the price and quality continuums. For budget women's sportswear, they will source completed products from less developed countries at low costs and for expensive designer fashions, they will coordinate manufacturing in numerous countries to ensure the highest quality product.

Similarly, there is a large amount of competition among agents and the direct sales forces for retailer shelf space. Major established brand names are often distributed by house sales representatives whereas more minor brands or new brands are often distributed by agents. In addition, there are elements of competition between distribution intermediaries depending upon the geographic market to be served. In general, major urban centres are most likely to be served by house representatives while more minor or rural markets are served by agents.

The highest levels of intrachannel competition are found at the retail level although the level of competition varies from Canada to the U.S. In Canada, a small number of retailers control a large share of the women's apparel market. Because of their size, these apparel specialty stores and department stores have relatively more power than their U.S. counterparts. As a result, they have more control over the amount of price competition among retailers. In addition, on a relative basis, the discounters are less established in Canada (particularly factory outlets) and this has also lessened the amount of price competition among retailers. In the U.S., the level of price competition is relatively higher due to the lower level of retail concentration when compared to Canada. In addition, manufacturers' factory outlets increase the price competition among retailers by lowering the consumers' expected retail price. A further reason for the higher levels of intrachannel competition among U.S. retailers is that the typical U.S. retailer is willing to accept a lower percentage markup than their Canadian counterpart. (This lower margin is expected to be made up through higher sales volume).

6.8 Margins

Across the women's sportswear industry, margins vary significantly depending on their price points, the number of levels in the distribution channel and whether the goods are being sold in the Canadian or U.S. market. As a result of this wide variance, the following numbers approximate typical margin ranges for products at moderate price points. Margins for products at budget and popular price points would typically have lower margins than moderate products, while products at better and designer price points would have more margin built into their pricing.

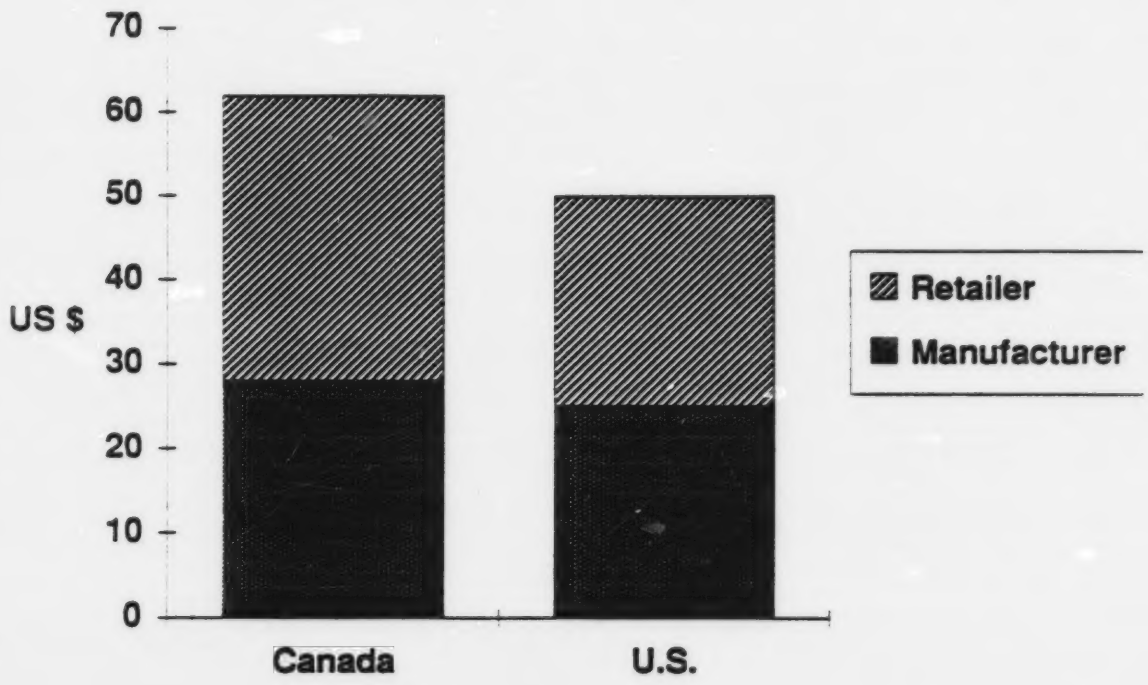
Similar to the bedding and linens industry, volume purchase agreements and other payment discounts are not figured explicitly in negotiations between apparel industry participants, rather they are negotiated up front as discounts on a case by case basis.

Margins also vary by channel participant within each distribution level. Domestic manufacturers usually markup products at moderate price points in the range of 80 to 120% over their total product costs. However, from this margin are subtracted the salary costs for the direct sales force as well as any commissions paid to sales agents. Similarly, contracting manufacturers markup their products 60 to 100% over their total product costs, again with salaries or commissions subtracted from this amount. Importers' markups display the most variance (50 to 500%) although it is unknown how much of this variance is a function of the products imported versus importers' general markups (i.e. not a large proportion of imported women's sportswear is targeted at moderate price points so imported products are typically lower or higher priced than moderate).

As previously stated, direct sales force and agent's costs are covered by the manufacturer's margins. Agents' commissions, range from 8% (for high volume brand names) to 20%+ for less well known or established products. The total costs associated with a particular agent also vary widely (this would be expected, given that they are paid solely on commission with no benefits) but are on average more costly to the company than a comparable direct salesperson.

Typical margins also vary by type of retailer. In general, department stores and apparel specialty stores have markups in the 80 to 100% range, while discounters tend to have markups of about 40 to 60%. Mail order and factory outlet stores tend to have lower markups than the other retailers (20 to 50%) although this may be more a function of the sources of information (i.e. mail order and factory outlet retailers account for very small volumes in Canada and as a result the findings that pertain to these channels were obtained from U.S. sources - the Canadian situation is assumed to be comparable) rather than retail positioning. In the *other* retail category, grocery stores tend to

Case 1 - Comparable Product Manufactured in Canada for Canadian Market and in the U.S. for U.S. Market and Sold by Direct Sales Force to Department Store



carry budget clothing with lower markups (roughly 20 to 30%), while sporting goods stores tend to carry more specialized high-end merchandise at better price points with commensurate higher margins (similar to department store or apparel specialty store margins). As already noted, there are some differences in margins between U.S. and Canadian retailers and these are noted in the following section.

6.9 U.S. and Canadian Margin Differences

In general, U.S. women's sportswear distribution channel members accept lower margins than their Canadian counterparts. There are four main reasons for these differences which follow. First, at each level of the channel, there are relatively more industry participants in the U.S. as compared to Canada. This increased level of competition drives lower margins on average. The second key reason is the relative lack of concentration among U.S. channel participants. In Canada, a small number of manufacturers, distributors and retailers account for larger percentages of total market volume. This leads to less price competition among participants. A third reason is the relative strength of brand name goods in the U.S. as compared to Canada. With less domination of brand name goods in Canada, there is less direct comparability of products across different channel participants. Fourthly, the Canadian retailers have not been subject to the increased price competition driven by the forward integration of manufacturers into the retail channels (specifically in mail order and factory outlets).

6.10 Margin Summary and Examples

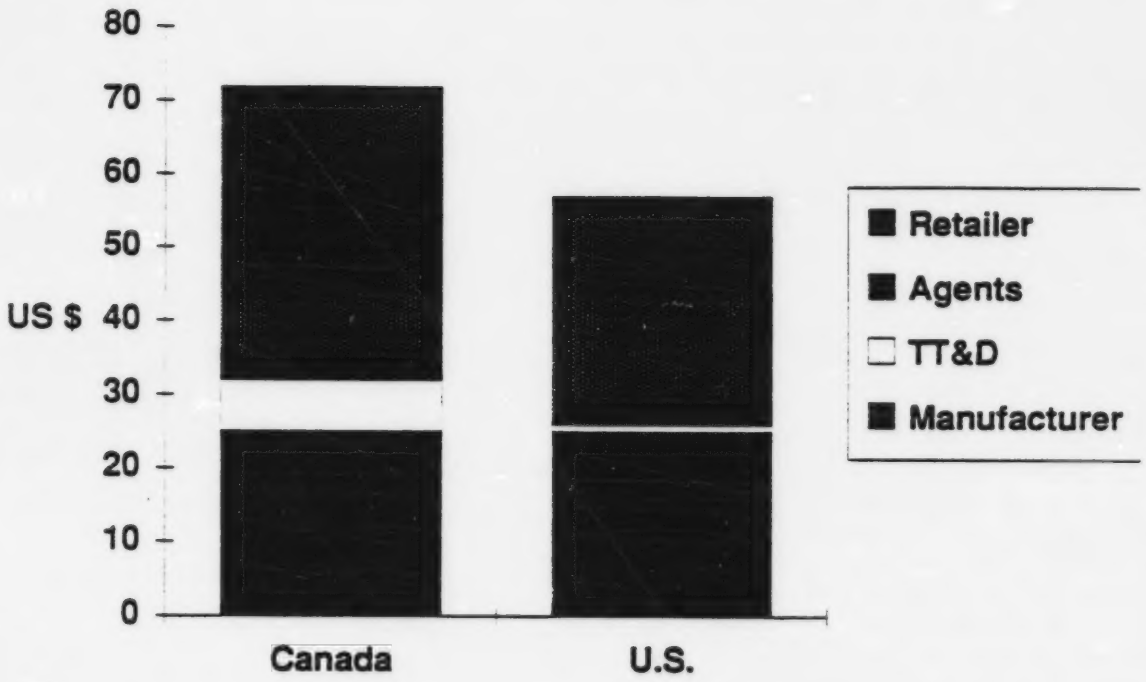
In summary, the following examples attempt to portray pictures of the margins and prices at each level of distribution for three representative women's sportswear products at moderate price points.

Case 1 - Comparable Product Manufactured in Canada for Canadian Market and in the U.S. for U.S. Market Sold by Direct Sales Force to Department Store

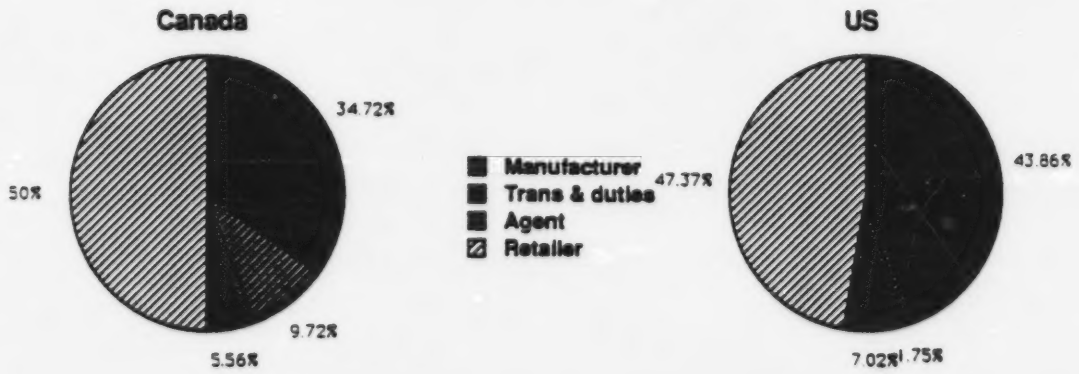
This case illustrates the differences between Canadian and U.S. manufacturers' costs, as well as the relative differences in markup between similar retailers on either side of the border. Note that the Canadian manufacturer's and retailer's costs are stated in U.S. dollars

Note: Prices are in U.S. $	Canada	%	U.S.	%
Ex-Manufacturer	$ 28	100%	$ 25	89%
Retailer (via Direct Sales)	$ 34	120%	$ 25	89%
Consumer's Price (U.S.$)	**$ 62**	**220%**	**$ 50**	**178%**
Exchange Rate ($1 U.S. = $1.16 Canadian)				
Canadian Consumer's Price	**C$ 72**			

Case 2 - Identical Product Manufactured in the U.S. and Sold by Agents to Apparel Specialty Stores



Percentage of Retail Price

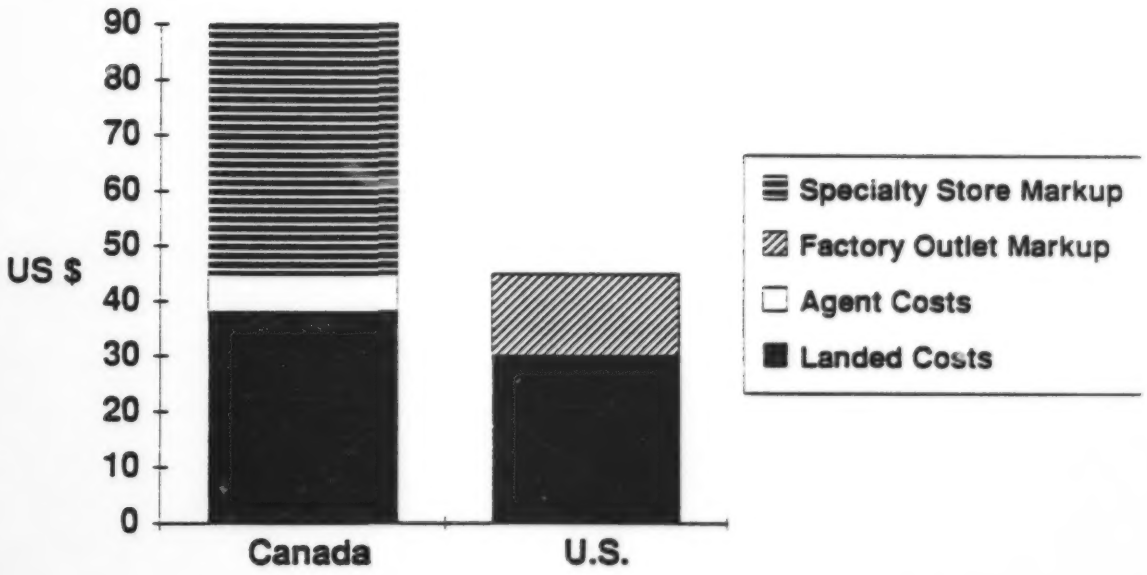


Case 2 - Identical Product Manufactured in the U.S. Sold by Agents to Apparel Specialty Stores

This case illustrates the level of Canadian tariffs and transportation costs, as well as the relative differences in markup between similar retailers on either side of the border.

Note: Prices are in U.S. $	Canada	%	U.S.	%
Manufacturer Costs (U.S.)	$ 25	100%	$ 25	100%
Tariffs	$ 5	20%	$ 0	0%
Transportation Costs	$ 2	8%	$ 1	4%
Agent Costs	$ 4	16%	$ 4	16%
Ex-Manufacturer	$ 36	144%	$ 30	120%
Specialty Store	$ 36	144%	$ 27	108%
Consumer's Price (U.S.$)	**$ 72**	**288%**	**$ 57**	**228%**
Exchange Rate ($1 U.S. = $1.16 Canadian)				
Canadian Consumer's Price	**C$84**			

Case 3 - Identical Product Manufactured Overseas Under Contract to U.S. Manufacturer, Sold By Manufacturer in Factory Outlet Store in the U.S. and Sold via Agent to "Upscale" Apparel Specialty Store in Canada



Case 3 - Identical Product Manufactured Overseas Under Contract to U.S. Manufacturer Sold by Manufacturer in Factory Outlet Store in the U.S. and sold via Agent to "Upscale" Apparel Specialty Store in Canada

This case illustrates one of the most frequent reasons for cross-border shopping for women's sportswear i.e. the "purchasing power differences" across price points. It also shows the large differences in margin between factory outlet stores and other retailers.

Note: Prices are in U.S. $	**Canada**	**%**	**U.S.**	**%**
Landed Costs (includes tariffs and transport)	$ 38	100%	$ 30	79%
Agent Costs	$ 7	18%	$ 0	0%
Domestic Market Costs	$ 45	118%	$ 30	79%
Factory Outlet Markup			$ 15	39%
Specialty Store Markup	$ 45	118%		
Consumer's Price (U.S.$)	**$ 90**	**236%**	**$ 45**	**118%**
Exchange Rate ($1 U.S. = $1.16 Canadian)				
Canadian Consumer's Price	**C$104**			

7. CONCLUSIONS

7.1 Preliminary Findings

Our research suggests that there are selected findings which apply to the sectors we have investigated, and others, based on the areas we reviewed, which may have more general applicability. These conclusions follow in order:

- Some of the retailers that are growing fastest offer the lowest prices. Canadian channels focused on margin retention may find themselves severely undercut by those firms prepared to trade this for volume, both in the U.S. and Canada. If Canadian firms retain their relatively higher margin levels, the price gap compared to U.S. discount operations will likely grow, as will the incentive for consumers to shop across the border;

- Canadians buy store and private label brands more often than their U.S. counterparts, a retailing strategy which makes comparison shopping within Canada, and between Canada and the U.S. more difficult, and may retain some customers for Canadian stores. More widespread promotion of store brands and models only available in Canada may serve to reduce price comparisons;

- While cross border shopping is likely affecting all distribution channels in Canada, it may be affecting the least price competitive ones the most. Typically, this means that the smallest retailers with the least bargaining power, in areas which have reasonable proximity to U.S. shopping, may be experiencing the greatest economic impact. This could be confirmed through additional research, and, if true, appropriate remedial action identified (see below).

Conclusions likely to apply to several industry sectors include:

- Many Canadian channels of distribution are less economic than their U.S. competitors for the following main reasons:

  - Larger U.S. volumes and increased competition both between levels of channels and within particular channel levels dictate lower prices at each level of distribution;

  - U.S. subsidiaries of off-shore parents are able to negotiate lower prices for comparable products than Canadian subsidiaries, in large measure the result of the strategic importance of the U.S. market. Canadian firms could represent their country to their parent firms as a test market for particularly risky innovation (much as some consumer products companies have done), although this could prove less successful for consumer electronics than for other categories of consumer goods, because of the greater important of time-to-market as a basis for competition;

  - U.S. retailers appear to operate with lower margins than their Canadian counterparts due to cost, volume and pricing considerations;

  - U.S. firms tend to have lower operating and overhead costs than Canadian firms. Real estate, taxes, duties, transportation, and other factors contribute to this cost differential;

- For those products made in the U.S., the Canadian subsidiary represents an additional distribution channel component from the perspective of a continental market, and usually results in an extra mark-up to cover costs such as double handling, warehousing, labelling and certification requirements, and direct and indirect marketing, sales and other costs which are incremental to the U.S. operation and which must be absorbed in the marketplace;

- The relative strength of discounters among retail channels in the U.S. (particularly manufacturer-owned factory outlets) has put additional pressure on margins throughout the distribution chain, but is now adding pressure on Canadian channels;

- The gray market is a significant factor in the retailing of products where price differentials have emerged between countries;

- In the U.S., there is more interchannel competition than in Canada, because domestic channels enjoy relatively more bargaining power with their suppliers. Several manufacturers/suppliers resist forward integration, or other channel conflict inherent in the design of distribution structures, to preserve the relationships they have with these important buyers. Thus, factory-direct style stores are unlikely to become a major feature of the Canadian retailing environment until suppliers are prepared to compete with some of their immediate customers. If the retailing trend to more store brands and non-traditional sourcing continues, suppliers may have little option but to do this, but industry structure suggests that many probably will not initiate such action, but rather respond in this way, if required.

Although additional research may be required to confirm the above assessment, it appears that some Canadian suppliers may not be price competitive with U.S. firms unless they consider a North-South alignment for physical goods distribution. Others may wish to compete on a non-price basis, such as service, or financing. If competing on price, where appropriate, suppliers may wish to consider separating the distribution of physical goods from that of intangibles, pursuing a North-South alignment for physical goods, while seeking to add value East-West in relevant intangible ways, such as in service distribution, communications (pre- and post-sale), stocking and financing. Given the apparently lower margin expectations of U.S. firms, including channel members, companies at all levels in the channel may wish to re-evaluate their margin volume trade-off, and perhaps modify their mark-up policies.

Additional research could help clarify whether these conclusions are generally applicable across different industry sectors and geographic regions, and provide further insight into the management of affected industries, companies and channels, as described below.

7.2 Outstanding Research Needs

Additional research in other product categories would help to confirm observations such as those presented above and further refine overall conclusions regarding the relative competitiveness of Canadian versus U.S. distribution channels.

Other areas for possible research follow:

- This study considered aspects of price competition, and reviewed input and output pricing at each stage of the channels of distribution to understand value addition. Service-based

competition did not form part of the Terms of Reference, and a project could be conducted to assess whether opportunities exist for Canadian firms to limit cross-border shopping by the creation or further development of service as a strategic barrier. Research could seek to understand:

- service vs. price market segmentation, specifically whether only price-sensitive consumers shop across the border, or if cross-border shoppers also include service-sensitive customers who either discount the value of service, or are not aware of the service issues associated with buying in the U.S., such as warranties and after sales support;
- whether shoppers are aware of the services they do not secure by shopping in the U.S.;
- the value they place on the services they do without;
- why they are prepared to forego specific services (e.g. warranty, after-sales support, home delivery, and so on), and options they have to secure required services in the after-market;
- where they would have spent their money had they been denied the opportunity of cross-border shopping, to understand which categories of channels are being most affected by cross border shopping, and what would have motivated them to buy in Canada; and
- how manufacturers, importers, retailers and other channel members use, or could use, service provision as a basis for limiting cross-border shopping.

- This study demonstrated that specific industry sectors in the U.S. form a greater component of GDP than is the case in Canada. Specifically, we found that wholesaling is a more significant factor in the make-up of the U.S. economy, likely comprised principally of manufacturers' sales branches and sales offices being relatively more important.

  A study could be conducted to assess the likelihood of structural change in the Canadian economy to favour the growth of these sectors, and the implications this would have on value creation in Canada. For example, some U.S.-based companies have begun to treat their Canadian operations as sales offices and others are now in the process of entry into the Canadian market on this basis. Could additional firms be attracted? In addition, many subsidiaries of U.S. and off-shore parents have made their business case for being in Canada to serve the distinct characteristics of the Canadian market. Now some firms of which we are aware are starting to doubt whether, aside from the Quebec market, there is sufficient need or market differences north of the U.S. border to warrant the costs associated with the maintenance of a subsidiary operation.

  A study could be conducted with head offices, whether in Canada, the U.S., or off-shore parent companies, serving the North American market to understand emerging structural and economic change in Canadian distribution channels brought about by strategic decisions of foreign firms, and how these decisions may be managed for advantage to Canadians. Specifically, the study could consider the likelihood and impacts of Canadian business consolidation into a North-South orientation, what elements of business will remain for serving the Canadian market, opportunities for serving border markets in the U.S. out of the Canadian subsidiary, and, for those U.S. firms not now in Canada, the requirements and basis for participation in the domestic market, including the channel structure that might be employed. This work would not consider product mandates (world or continental) for much has already been done in this area. Rather it would examine how distribution channels could serve as a basis for increased value addition in Canada, or how current levels may be retained. For example, where U.S. based firms are preparing to

reorient their distribution channels on a North-South basis, the assignment could explore whether the distribution channel could be "unbundled" to let the physical goods be distributed out of the U.S., while saving components of value creation for Canada, such as distribution channels for service, promotion, communication (pre- and post-sales), customer handling, and other non-product elements which are currently bundled with goods distribution;

- The gray market has become a significant factor in the marketplace, undermining pricing and value enhancing strategies for many Canadian suppliers and importers. Some individuals buy at lower prices in the U.S., foregoing after-sales service from authorized dealers in the process, some companies consolidate their North American purchases to secure continental purchasing economies (such as in the personal computer industry) and some members of distribution channels by-pass their domestic sources to seek lower cost goods in the U.S., or elsewhere. An assignment could be conducted to assess the magnitude and impact of the gray market on specific industry sectors, and strategies that companies use to manage their business in this environment;

- This study considered *goods* bought in the U.S. Based upon our survey of residents of Sault Ste. Marie, we know that there is considerable leakage from the Canadian economy for *services*, and ISTC may wish to consider the impacts of cross border service procurement, such as financial services (banking, insurance, stock brokerage, financial planning), hospitality, and vehicle maintenance and repair;

- This study considered the margin implications in the building of value at each stage in the channel of distribution. ISTC may wish to probe further and examine in detail the components of cost structure that lead to the margins that we have identified;

- This study confined itself to three product categories and one geographic region. Expansion to include other categories and regions may be appropriate. In addition, after receiving feedback from industry participants in the three sectors under consideration, further work associated with this study may be desirable;

- This study focussed on margins at each level of the distribution channel without examining costs in detail. During our research, we became aware of low-cost retail location opportunities situated in the U.S. close to the Canadian border. Further research could be conducted to examine the amount of subsidies (for commercial properties) that U.S. manufacturers, distributors and retailers receive from the state and municipal governments and how this impacts the competitiveness of Canadian versus U.S. distribution channels.

APPENDICES

APPENDIX A

List of Sources

List of Organizations Contacted

Canada

Government

- External Affairs and International Trade
  U.S. Branch
  U.S. Tariffs and Market Access Division
- External Affairs and International Trade
  U.S. Trade and Tourism Development Division
- Industry Trade and Technology
  Domestic Industries Branch
- Industry Trade and Technology
  Investment Marketing Group
- International Development Research Centre
  Resources, Property, Material and Traffic Services
- Statistics Canada

Research Organizations and Business Periodicals

- C.D. Howe Institute
- Conference Board of Canada
- Economic Council of Canada
- Marketing Magazine
- Materials Management and Distribution Magazine
- Sales and Marketing Management in Canada
- various Banks economists

Industry Associations

- Canadian Apparel Manufacturers Institute
- Canadian Association of Wholesale Sales Representatives
  represents wholesalers of women's clothing
- Canadian Hardware and Housewares Manufacturing Association
- Canadian Manufacturers Association
- Consumer Electronics Marketers of Canada
- Industrial Marketing and Research Association of Canada

United States

Government

- U.S. Department of Commerce
  Bureau of the Census

Industry Associations

- U.S. Apparel Manufacturers Association
  Transportation and Distribution Committee
- Bureau of Wholesale Sales Representatives
  members are apparel representatives
- Electronic Industries Association
- International Electronics Federation
  members are associations in electronics industry
- International Mass Retail Association
  association of retail chains
- International Material Management Society
- Institution and Service Textiles Distributors Association
- Material Handling Institute
- National Association of Retail Dealers of U.S.
  was appliance and radio/tv dealers association
- National Association of Wholesaler-Distributors
  Distribution Research and Education Foundation
- National Housewares Manufacturers Association
- National Retail Federation
- Professional Audio-Video Retailers Association
- Sportswear Apparel Association

APPENDIX B

Annotated Bibliography of Relevant Sources

Canadian Reports

- Halifax-Dartmouth Port Development Commission. *Diversion of Canada's Overseas' Trade Over U.S. Ports: Countering the Threat,* December 17, 1990.
  - looked at issues that impinge on the ability of Canadian ports to compete
  - study was done internally by the Commission to try to convince the federal government to change the rules that relate to ports and put the ports, and thus rail service at a disadvantage vis a vis the U.S.
  - the study would have covered the three commodities being researched, but it was done with a container orientation, vs. a product orientation, and therefore doesn't contain any information specific to those three commodities
  - study wasn't released publicly
- Study by The Container Competitiveness Committee (or CCC Study)
  Arnold Masters, Committee Chairman
  Canada Ports Corporation
  - study was just accepted by the CPC Board and will be sent to the Minister shortly
  - Committee will be required to provide some information to those who appeared, so there is a possibility a semi-public version of the report will be issued in 2-3 months
  - competitiveness study of Canadian ports
    - talked to shippers, shipping lines, freight forwarders, railroads, truckers, etc. as well as individuals, such as the Ontario Liquor Commission which has a lot of container traffic
    - report also includes background technical papers on various topics including: shipping economics and trends; railroad economics as they relate to container ports; and port problems
  - a Container Competitiveness Study was also done in 1988 by the Corporate Services Section, which covered such issues as pricing, markets being served, shipping line costs, railway issues, computer services, financing of ports and police and security services
- Physical Distribution Study
  Ontario Furniture Manufacturers Association
  Phase 1 - April, 1991
  - Phase 1 will document the structure of distribution channels in Canada, Phase 2 the U.S., and Phase 3, internationally
  - in Canada most transportation costs are borne by the retailer, versus the U.S., where the manufacturer covers transportation costs
  - in the U.S. it is estimated that furniture can be shipped at half the Canadian cost
  - retailers in Canada are putting pressure on manufacturers to reduce these costs
  - as tariffs decrease under free trade, retailers have greater access to U.S. product
- Canadian Retail Apparel Buyers
  Image and Awareness Study
  October - November 1990
  - based on 55 interviews conducted with retail apparel buyers in Canada, conducted by the Nashville Consulting Groups in Nashville, Tennessee
- Statistics Canada
  - Wholesale trade statistics, Catalogue 63-226 Annual
  - Wholesale trade, Catalogue 63-008 Monthly
  - Annual retail trade, Catalogue 63-223 Annual
  - Retail trade, Catalogue 63-005 Monthly

- A Report on Outshopping in Thunder Bay
  Ernst & Young
- Cross-Border Shopping in the City of Sault Ste. Marie, Ontario
  Ernst & Young
- The 1990 Operating Survey of Canadian Retailing
  Ernst & Young, for the Retail Council of Canada

Canadian Articles

- Apparel Retailing in Canada
  Randolph Harris
  EIU Textile Outlook International
  September 1990
  p. 81-96
- Tune in to the best distribution channel
  Jerry Zeidenberg
  Small Business
  April, 1990
  p. 45

U.S. Reports

- 44th Annual Survey of Distributor Operations
  What's Your Share?
  1989 Survey of Industrial Distribution Magazine
  July 1990
  p. 23-36
  300+ page report containing original statistics on general line, specialty and combination distributors. Operations are measured by type of firm, sales size, and by six geographic regions. Its contents are divided by vital statistics, warehousing, management, sales & profits, operating costs, inventory and receivables, and computers. A single copy is $195 pre-paid, $250 if billed. Contact: Diane Mercurio, ID, P.O. Box 37, Boston, MA 02258. Or call 617-558-4346.
- National Association of Wholesaler-Distributors
  The Technology Maze in Wholesale Distribution
  Choosing the Right Path
  Published by Distribution Research & Education Foundation
  National Association of Wholesaler-Distributors
  Prepared by Arthur Andersen & Co.,S.C.
- Financing Wholesale Distribution in the 1990's
  Published by Distribution Research & Education Foundation
  National Association of Wholesaler-Distributors
  Prepared by Deloitte and Touche
- U.S. Distribution Journal Annual Survey
  Going Back To Basics
  U.S. Distribution Journal
  December, 1990
  p. 39-45
- Ernst & Young Wholesale Industry Analysis
  December 1990
- Ernst & Young's 1990's Survey of Distribution, Transportation & Warehousing Trends in Retail
  Ernst & Young, for Stores Magazine, the National Retail Federation
- U.S. Department of Commerce
  Bureau of the Census
  - 1987 Census of Wholesale Trade, WC87-A-52
  - 1987 Census of Retail Trade, RC87-A-52
- U.S. Department of Commerce
  Bureau of the Census
  Current Business Reports
  - 1989 Wholesale Trade, BW-89-13
  - Monthly Wholesale Trade, Sales and Inventories, BW90-12
  - Monthly Retail Trade, Sales and Inventories, BR90-11

- Arthur Anderson & Company, Inc.
  Future Trends in Wholesale Distribution
  Washington, D.C.
  Distribution Research and Education Foundation
  1983

- Foreign Direct Investment by Acquisition: A Comparison of the Market Access Characteristics of Foreign and Domestically-Acquired United States Manufacturing Firms
  Author: Shaw, Kenneth Edward
  Degree: Ph.D.
  Year: 1989
  Institution: Syracuse University
  Volume 50/07-A of Dissertation Abstracts International. Page 2161. 346 pages.
  - This study of market access characteristics of foreign and domestically acquired United States manufacturing firms is based on the responses to a questionnaire mailed to 396 U.S. manufacturing firms which had been acquired in 1986 and 1987.One of the findings of the study was that foreign acquired manufacturers employed more direct means of distribution and had lower rates of turnover among intermediaries in their distribution channels.

- Economic Analysis of Marketing and Distribution
  Author: Nariu, Tatsuhiko
  Degree: Ph.D.
  Date: 1989
  North Carolina State University at Raleigh
  Volume 50/05-A of Dissertation Abstracts International. Page 1399. 117 Pages.
  Economic theories of information gathering, strategic behaviour, opportunism, and response to externalities afford logical interpretations of various marketing phenomenon. Some of the points discussed include the following:
  - Consumer's information gathering behaviour determines to some degree the appropriate physical distribution paths and methods of sales promotion.
  - Manufacturers and retailers will often have information about the future demand that is not known to the other. Efficiency requires that each member of the distribution channel has an appropriate incentive either to act on its private information or to to reveal it to other members.
  - Manufacturers encounter externality problems in distributing their products through independent retailers and respond by imposing vertical restraints. In this setting, manufacturers can induce retailers to sell to non-brand loyal consumers only be imposing exclusive dealing, and can deter retailers from exploiting the manufacturers' own monopolies only be imposing other vertical restraints.

U.S. Articles

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- Managing Multiple Channels
  Frank V. Cespedes and E. Raymond Corey
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- How You'll Manage Your 1990s 'Distribution Portfolio'
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- High cost of direct sales spurs strong partnerships
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  September, 1990
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  Doug Harper
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  International Trade Administration
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  Joseph Ellis
  Retail Control
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APPENDIX C

Glossary of Terms

Glossary of Terms

Agents, Brokers and Commission Merchants	Agents, brokers and commission merchants buy or sell products owned by others on a commission or agency basis.
Department store	A department store is defined as a retail outlet that has both breadth and depth of product lines, including: - Family clothing and apparel; - Furniture, appliances and home furnishings; - Household linens and dry goods.
Interchannel Competition	Interchannel competition refers to rivalry between different categories of channel participants, such as retailers competing with a manufacturer's direct sales force.
Intrachannel Competition	Intrachannel competition refers to rivalry between channel participants at the same level in the distribution channel, such as department stores competing with one another.
Manufacturer's Sales Branch	Manufacturer's sales branches and offices are owned by manufacturing enterprises, but maintained apart from their plants for the purposes of marketing their products.
Margin	Margin refers to a percentage of the selling price. E.g. Bought product at $30, sold it at $40, Margin is 25%
Markup	Markup refers to a percentage of the cost at which a purchase was made. E.g. Bought product at $30, sold it at $40, Markup is 33%
Mass merchandiser	Refers to high volume retailers who are often market leaders in many locations. Examples include Zellers, K mart, Wal-Mart Stores and Sears.
Wholesale Merchants	A wholesale merchant (or merchant wholesaler), is an establishment which handles merchandise on its own account, i.e., takes ownership of merchandise in the course of doing business. This group includes jobbers, industrial jobbers, industrial distributors, voluntary group wholesalers, drop shippers, retailer cooperative warehouses, terminal elevators, and cooperative buying associations.